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No.

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1982

GRACE CAPPUCCILLI, DOROTHY CAPPUCCILLI, GERALD F. PADUANO and CAROLINE PADUANO,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTION PRESENTED — ISSUE ONE

Section 482[1] of the Internal Revenue Code of 1954 (26USC) and the Treasury Regulations thereunder authorizes the Commissioner to impute interest income on loans between controlled parties where a reasonable rate of interest has not been charged.

The question presented is whether the Commissioner may, under Section 482, impute interest income to CCP for the years 1970-1971-1972 on interest free loans and mortgage which it made to Stonehedge, a controlled related party, where CCP, received no imputed interest payment and where the payment of said interest to CCP from Stonehedge was prohibited by legal disability. The Second Circuit Court of Appeals affirmed the U.S. Tax Court in upholding the Commissioner's determination.

QUESTION PRESENTED — ISSUE TWO

The Second Circuit Court of Appeals in a landmark case upheld the Commissioner's right under Section 482 to impute interest income on interest free loans between related parties. *B. Forman Co. v. Commissioner,* 453 F.2d 1144 (2d Cir. 1972), cert. denied, 407 U.S. 934 (1972), rehearing denied, 409 U.S. 899 (1972).

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[1] Title 26 USCS Section 482 provides:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

The question presented is whether the Commissioner's ten year retroactive application of Section 482 for the years 1970-71-72 to an interest free mortgage (of $1,075,000) executed in 1962 by CCP and Stonehedge is so arbitrary and oppressive as to violate the Petitioners' Fifth Amendment rights under the constitution.

QUESTION PRESENTED — ISSUE THREE

If the Court holds for the Commissioner on Issues One and Two, then: the question presented is whether the Commissioner's imputation of interest income to Paduano a partner of CCP (having three equal partners) at a time when CCP had interest free loans and mortgage due from Stonehedge and Seneca corporations which were totally owned by the other two partners, violates the Fifth Amendment rights of Paduano who has no interest in the corporate obligors.

QUESTION PRESENTED — ISSUE FOUR

The Petitioners who were assessed income taxes on imputed interest income (under Section 482) for the years 1967-1972, attempted to take a tax deduction in 1975 when the imputed interest income was deemed to be uncollectible.

The Tax Court denied Petitioners' deduction on the theory that any such deduction should be taken in 1976, (App. D, *infra*, 40a, 41a) a year not before the Tax Court. *Affirming the denial of the deduction on entirely different grounds*, the Second Circuit Court of Appeals held that Petitioners were seeking a double deduction. (App. A., *infra*, 6a).

The question presented is whether the denial of a tax deduction to Petitioners on uncollected and uncollectible imputed interest income on which taxes were assessed (and paid) constituted a violation of Petitioners' Fifth Amendment rights.

QUESTION PRESENTED — ISSUE FIVE

For purposes relevant to this issue, Section 1221 defines "capital asset" as

> "property held by the taxpayer (whether or not connected with his trade or business), but does not include —
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"
>
> Section 1221(1)

The United States Tax Court held that CCP recognized ordinary income and not capital gain on the sale of vacant land to Stonehedge in 1962 because CCP was a developer. This holding was based not on CCP's activities but on an erroneous principle of law, a joint venture theory, in which the Tax Court attributed Stonehedge's development activities to CCP. The Second Circuit Court of Appeals which did not embrace the Tax Court's joint venture theory, nevertheless, on an entirely different theory affirmed.

The question presented is whether the Second Circuit Court was justified in making a finding that CCP sold the subject property in the ordinary course of its trade or business under Section 1221(1) where the Tax Court's findings of CCP's lack of development activity were not clearly erroneous.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Victor Chini, attorney at law, on behalf of Grace Cappuccilli, Dorothy Cappuccilli, Gerald F. Paduano and Caroline Paduano, petitions for a writ of certiorari to review the judgment of the United States Second Circuit Court of Appeals in this case.

OPINIONS BELOW

The opinion of the Second Circuit Court of Appeals (App. A, *infra,* 1a-10a) affirming the United States Tax Court is reported at 668 F2d 138 (2d Cir. 1981), 82-1 USTC §9118, p. 83059. The United States Tax Court opinion (App. D, *infra,* 14a-45a) is reported at T.C. Memo 1980-347; 40 TCM 1084.

JURISDICTION

The opinion of the Second Circuit Court of Appeals was filed on December 29, 1981. The judgment of the Second Circuit Court of Appeals was also entered on December 29, 1981 (App. C, *infra*, 12a, 13a). The order denying rehearing en banc was entered on January 27, 1982 (App. B, *infra*, 11a). The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

STATUTE AND REGULATIONS

The relevant provisions of Sections 165, 166, 482, 6601 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Treasury Regulations, Sections 1.166-1(a)(1) and (2), 1.166-1(c), 1.482-1(a)(3), 1.482-1(a)(6), 1.482-1(b)(1), 1.482-1(b)(3), 1.482-1(d)(1) and (2), 1.482-2(a)(1) (26 C.F.R.), and Revenue Procedure 65-17, Section 3.02, 4.02 1965-1 C.B. 833, are set forth at App. D., *infra*, 50a-66a.

STATEMENT

1. In 1954, brothers Peter and Rocco Cappuccilli formed a partnership with Gerald Paduano hereafter referred to as CCP. Each partner had a one-third interest in the partnership. (App. A, *infra*, 3a). The three partners had organized the Stonehedge Development Corporation (Stonehedge) in April of 1953 and subsequently organized the Seneca Sewerage Corporation (Seneca) in April of 1961. The stock of Stonehedge and Seneca was owned equally by the Cappuccilli brothers and Paduano until May 26, 1969 when Paduano retired his stock in the corporations and the Cappuccilli brothers became 100% owners of both corporations. Paduano remained a partner in CCP throughout all of the years in question. (App. A, *infra*, 3a).

All parties filed joint tax returns but, as the Cappuccilli's filed bankruptcy petitions in 1977, the deficiencies were assessed against their wives. (App. A, *infra*, 3a).

2. In February of 1958 the partnership, CCP, began to acquire options to buy farm lands adjoining a tract of land developed by Stonehedge in 1955. (Jt. Ex. 19-S; R. 3) (App., *infra*, 64a)

In 1960-1962, CCP exercised the options that it had acquired and purchased a number of individual parcels at a cost of $445,723.00 to assemble a tract known as Seneca Knolls farms. CCP made no attempt to improve or subdivide the tract and subsequently (after a holding period in excess of six months)[2] sold the tract to Stonehedge for a sales price of $1,570,327.39 consisting of assumption of mortgages, cash and two promissory notes, one for $81,000.00 at six percent interest and one noninterest bearing mortgage note of $1,075,000.00. (App. A., *infra*, 3a, 4a; App. D, *infra*, 17a-19a).

On April 15, 1961, CCP purchased a different parcel of land, the Preston Farm, from Stonehedge for $25,000.00 and resold it the next day to Seneca for $40,000.00 which included a promissory note for $25,000.00 at six percent interest. (App. A., *infra*, 4a).

3. Neither Stonehedge nor Seneca paid CCP any interest on their respective mortgages. (App. D, *infra*, 21a).

> Zoning problems prevented Stonehedge from developing the land. From 1970 to 1975, Stonehedge borrowed $500,000.00 from the Merchants National Bank & Trust Co., on the security of a pending eminent domain claim against New York State, and in 1972 the corporation sold land for $223,756, paying the proceeds to CCP. But from 1970 to 1972, CCP had to advance cash to Stonehedge to keep the corporation going. Stonehedge's debt to CCP for these advances once totalled $120,000. Stonehedge managed to repay these advances, but never paid any interest on them. In 1972, Stonehedge reconveyed part of the Seneca Farms to

[2]Including the option periods (since 1958) CCP had effective control on all farms for an average of 43 months. (Jt. Ex. 19-S; R. 3) (App., *infra*, 64a)

CCP and CCP foreclosed on the remainder, in full satisfaction of Stonehedge's obligations to the partnership. Because CCP had received payments on the notes while Stonehedge was in possession of the land, CCP recognized gain to the extent of those payments — $482,577 — upon repossession under I.R.C. Sec. 1038. CCP reported this gain as capital gain.

(App. A, *infra*, 4a).

4. The Commissioner concluded that the lack of interest recognized by CCP on the mortgages to Stonehedge and Seneca understated the true income of the partnership and, pursuant to Section 482 of the Internal Revenue Code, allocated some $325,718.90 in "interest income" to CCP for 1967-1969. The Commissioner simultaneously credited the corporations with an interest deduction in the same amount and the allocation was upheld in *Paduano v. Commissioner*, 538 F.2d 312 (2d Cir. 1975), *cert. den.*, 425 U.S. 992 (1976). (App. A., *infra*, 4a).

In 1975, Stonehedge merged with Community Technology, Inc. (CTI), which filed a Chapter XI bankruptcy petition in 1976. CCP filed a claim for $325,718.90 in interest income from Stonehedge as allocated by the Commissioner for the years 1967-1972. In February 1978 the Bankruptcy Court denied the claim, holding that the Commissioner's allocation imposed no obligation under New York law, on CTI to pay interest to CCP. (App. A., *infra*, 5a).

In its amended partnership return for 1975, signed August 13, 1976, CCP claimed a bad debt deduction for the interest allocated for 1967-1969 and subsequently filed amended returns for 1975 and refund claims to carry back the net operating loss to the taxable year 1972. (App. A, *infra*, 5a).

5. The Commissioner denied the 1967-1969 deduction and refund and allocated another $132,088.70 in interest income from Stonehedge and Seneca for 1970-1972. The Commissioner also determined that CCP's gain on the foreclosure and

repossession of land from Stonehedge was ordinary income and not capital gain. (App. A, *infra*, 5a).

6. The Tax Court sustained the Commissioner's determinations and the Second Circuit Court of Appeals affirmed the decision of the Tax Court, under different theories holding:

a) For the years 1967-69; no bad debt deduction was allowed to CCP on interest income of $196,380 which was imputed from Stonehedge and upon which CCP had paid a tax, and which interest it could not collect.

b) For the years 1970-72; the Commissioner could impute interest income of $129,339 to CCP from Stonehedge; also CCP could not claim a bad debt loss for that amount even though said interest was uncollectible.

c) CCP's gain on repossession of land from Stonehedge was ordinary income, not capital gain. (App. A, *infra*, 3a).

REASON FOR GRANTING CERTIORARI ON ISSUE ONE

The holdings of the Courts below in imputing interest income where a legal disability exists as to collection appear to be in direct conflict to the holding of this Court in *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, (1973) which held that:

> Since the taxpayers (banks) received no premium insurance income, and were legally prohibited by law from receiving any such income, the Commissioner's allocation to the taxpayers under Sec. 482 was not warranted.

As Justice Powell of this Court said:

> "We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. In cases dealing with the concept of income, it

> has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it."

405 U.S. 394, 403.

In the instant case, the sale by CCP to Stonehedge providing for an interest free mortgage took place ten years prior to the Second Circuit Court's decision in, *B. Forman Co. v. Comm.*, 453 F.2d 1144 (2d Cir. 1972), cert. den. 407 U.S. 934 (1972), which upheld the Commissioner's authority to impute interest on loans between related parties. Prior to the *Forman* case, *(supra)*, and at the time of the transactions relevant to the case at bar, a long series of cases held that the Commissioner could not "create" income that was not actually or constructively received.

In fact, prior to the *Forman* case in 1972, *there was neither legal nor theoretical justification* for the payment of interest on a non-interest bearing loan between related parties. *Mertens, Law of Federal Income Taxation* Vol. 7 Sec. 38.63 at p. 160; See also: *Forman, (supra)* 453 F.2d at 1144, 1155-1156.

In 1978 CCP filed a claim in the Bankruptcy Court in an attempt to recover the interest that had been imputed by the Commissioner from Stonehedge in the amount of $325,718.90 for the years 1967-1972. The Bankruptcy Court denied CCP's claim on the ground that no liability existed under New York law and held that CCP was prohibited, by law, from collecting the imputed interest. (App. E, *infra*, 46a-49a).

Since the Commissioner argued in the Bankruptcy Proceedings (of CTI) that no valid obligation was created by the income allocation under Section 482, it is clear that the imputation of interest income under Section 482 creates an uncollectible debt and results in a tax on proceeds that would not, and could not, have been paid.

In *Corn Exchange Bank v. U.S.*, 37 F.2d 34 (2d Cir. 1930), (involving an accrual basis taxpayer), the Court said at page 34:

> "When a tax is lawfully imposed on income not actually received, it is upon the basis of a reasonable expectancy of its receipt, but a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when in point of fact it never was received."

In *Commissioner v. First Security Bank of Utah, supra,* this Court held that the Commissioner could not allocate insurance commission income under Section 482 to banks which had not received the income and were prohibited by federal banking law from receiving said commissions. This same principle has been extended by other courts and applied to cases where, as here, taxpayers were precluded from collecting imputed or "phantom" income due to prohibitions in state laws.

In *Delta Life Insurance Company v. U.S.*, 363 F. Supp. 410 (1973) the court held that where a life insurance company was required to maintain certain reserves under Louisiana law, the IRS is precluded from imposing a smaller reserve which would result in higher taxes. The *Delta* court cited *First Security Bank of Utah, supra,* stating:

> "The bank simply lacked the requisite power to receive the income. Likewise, Delta lacked the power under state law to maintain a smaller reserve." (363 F. Supp. at 415)

In *Owen W. Bunker,* T.C. Memo 1979-174 (1979), the Commissioner attempted to tax a bank on a certain stock gain, based on an argument that the bank was the real owner of the stock. The Tax Court held that since the state banking law prohibited the bank from owning the stock in question, the Commissioner could not tax the bank on the stock gain.

In *Bank of Coushatta v. U.S.*, 650 F.2d 75 (5th Cir. 1981), the Fifth Circuit held that, where a bank transferred its credit

insurance operation to individual agents based on its good faith belief that it would have been illegal for the bank to continue to earn and receive insurance commission income, the Commissioner could not allocate commission income to the bank under Section 482 because the bank did not actually, or constructively receive the income. The Court responded to the government's argument that the reasoning in the *First Security Bank of Utah* case *(supra)* was limited to cases where it would be *illegal* for the taxpayer to receive the income stating:

> "The Supreme Court clearly did not hold that a showing that it would be illegal to receive commissions is essential for a plaintiff to prevail in a similar situation. Rather, the fact that the banks could not legally have received the commissions was cited as proof that the funds were not diverted away from them by the holding company. The issue in this case is whether Coushatta received the commission actually or constructively as income."
>
> 650 F.2d 75, 77.

In *U.S. v. Basye*, 410 U.S. 441 (1973) this Court held that the reasoning in *First Security Bank of Utah, supra*, does not apply where taxpayers were contracting parties that agreed to deflect their income to a retirement trust for their benefit.

The critical factor distinguishing the *Basye* case, *(supra)*, from the case at bar is that while the taxpayers in *Basye* attempted to defer the taxation of their earnings, the taxpayers in the instant case had no real income to deflect or defer. The alleged income in the case at bar is comprised solely of phantom interest created by the Commissioner and then allocated to CCP. Also, prior to *Forman, supra*, the taxpayers were conducting business within the legal framework of state law and federal tax laws.

As Justice Powell of this Court stated in the *First Security Bank of Utah, supra:*

> "The 'complete power' referred to in the regulations hardly includes the power to force a subsidiary to violate the law."
>
> 405 U.S. at 405

This is precisely what the Commissioner is requiring of Stonehedge. If prior to *Forman* (1972) *supra*, Stonehedge had deducted interest on its tax returns for those years, Stonehedge and its officers would have violated not only state law — but also the Federal Income Tax Laws — because its returns would have been fraudulent.

It is clear from the foregoing that the holding of the Courts below directly conflicts with the principle enunciated by this Court in *Commissioner v. First Security Bank of Utah, (supra)*. The extent of the Commissioner's ability to create, allocate and then tax income that was uncollected and uncollectible raises numerous questions of far-reaching consequences and should be addressed and clarified by this Court so that this area of the income tax law may be administered more fairly, uniformly and equitably.

REASON FOR GRANTING CERTIORARI ON ISSUE TWO

The treasury regulations authorizing the Commissioner to allocate interest income based on loans between related parties were not *proposed* until four years after the sale by CCP (1962) to Stonehedge and were not adopted until 1968, some six years after the transaction in issue. Treas. Regs. Section 1.482-2(a)(1); Section 1.482-2(a)(2).

Even after the adoption of the aforementioned regulations in 1968 it was another four years before the Second Circuit Court's decision in *B. Forman Co. v. Comm., (supra)*, in 1972 upheld the Commissioner's authority to impute interest on loans between related parties where no interest rate had been expressly stated.

This Court in several cases has upheld the retroactive application of the income tax laws involving periods of twelve months or less, as not violating the due process clause of the Fifth Amendment. See *U.S. v. Darusmont*, 449 U.S. 292 (1981) reversing and remanding District Court 80-2 USTC §9671, p.85208, and cases cited therein.

In that case this Court stated:

> "This 'retroactive' application apparently has been confined to short and limited periods required by the practicalities of producing national legislation. We may safely say that it is a customary congressional practice."

However, petitioners are of the opinion that their situation is analogus to that of the individual referred to by Judge Hand, who "has no reason to suppose that any transactions of this sort will be taxed at all". *Cohan v. Commissioner*, 39 F.2d 540, 545 (2d Cir. 1930).

It is clear from the facts in this case however, that unlike the taxpayers in *Cohan (supra)*, the taxpayers herein had no reason to suppose that the transactions entered into in 1961-1962 would, or could, be taxed. It was not until after *Forman, supra*, some ten years after the transactions, that the novel idea that the Commissioner could create and impute interest income not actually charged by related parties was accepted.

The Commissioner's retroactive application of Section 482 in this case constitutes such an unduly harsh, oppressive and arbitrary assessment of the taxpayers as to amount to a confiscation in violation of their rights to due process under the Fifth Amendment. *Heiner v. Donnan*, 285 U.S. 312 (1932); *Nichols v. Coolidge*, 274 U.S. 531 (1927).

REASON FOR GRANTING CERTIORARI ON ISSUE THREE

Section 482 was designed to prevent tax avoidance between related business entities and to treat related parties as non-related parties in similar business transactions. With respect to the time period involved (1970-71-72) it cannot be said that Paduano was related in any way to the corporate obligors (Stonehedge and Seneca).

There is no language in that statute, the regulations or the legislative history of Section 482 to warrant the holding that a party who derived no economic benefit on an interest free loan, must nevertheless, because of his status as a partner, at the time that the loan was made, be charged with income taxes.

As Justice Powell of this Court stated:

> "We know of no decision of this Court wherein a person has been found to have a taxable income that he did not receive . . . In cases dealing with the concept of income it has been assumed that the person to whom the income was attributed could have received it. *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 at 403 (1972).

In his concurring opinion in the Court below, Judge VanGraafeiland raised the constitutionality of charging income tax to Paduano, stating:

> "In May 1969, Mr. Paduano relinquished all of his interest in Stonehedge Development Corporation and Seneca Sewerage Corporation. The only evidence presented in the Tax Court indicated that, although Paduano remained a nominal partner in CCP, he in fact retired from active participation in that partnership. Despite these undisputed facts, Mr. and Mrs. Paduano have been held liable to pay a tax on nonexistent income allocated from the corporations to the partnership and which, of course, the Paduanos never received.

> When actual partnership income is involved, the law is clear that each partner must pay a tax on his distributive portion of that income. *United States v. Basye*, 410 U.S. 441, 448 (1973). However, "(t)hat which is not in fact the taxpayer's income cannot be made such by calling it income." *Hoeper v. Tax Commission*, 284 U.S. 206, 215 (1931). Taxable income contemplates the existence of an economic benefit which is subject to the dominion and control of the taxpayer. *Commissioner v. Kowalski*, 434 U.S. 77, 83 (1977); *Commissioner v. First Security Bank*, 405 U.S. 394, 403 (1972). Because the Paduanos had no interest in or control over the corporations during the taxable years in question and derived no benefit whatever from the interest-free loans to those entities, the allocations of income from the corporations to the Paduanos has constitutional implications which are bothersome. Although courts look upon tax legislation with an indulgent eye, a levy which is so arbitrary and capricious as to amount to confiscation may be held to violate the Fifth Amendment. *Heiner v. Donnan*, 285 U.S. 312, 326 (1932); *Nichols v. Coolidge*, 274 U.S. 531, 542 (1927).
>
> (App. A, *infra*, 8a, 9a)

The application of Section 482 in this instance constitutes an unwarranted and unreasonable interpretation of that statute, and a violation of Mr. Paduano's constitutional rights under the Fifth Amendment. Cf. *U.S. v. Vogel Fertilizer Co.*, 82-1 USTC §9134, p.83116 (S.Ct. 1982).

REASON FOR GRANTING CERTIORARI ON ISSUE FOUR

The Courts below disallowed the taxpayers the right to take a deduction for the imputed interest income that was neither collected nor collectible and this Court should grant certiorari to review this finding for the following reasons:

1) The Second Circuit Court of Appeals affirmed on a different theory than the Tax Court. *Reisman v. Caplin*, 375 U.S. 440, (1964).

2) The Second Circuit Court applied an incorrect principle of law (its double deduction theory) in that it ignored the separate entities of Petitioners (CCP) and Stonehedge. This Court recognized that a corporation is a separate taxable entity. *Moline Properties, Inc. v. U.S.*, 319 U.S. 436 (1943). It is well settled that in determining the trade or business of a taxpayer, the business activities of a closely held corporation will not be attributed to the taxpayer absent a showing of exceptional circumstances. See, *Burnet v. Clark*, 287 U.S. 410 (1932); *Jarvis v. Commissioner*, 32 T.C. 173 (1959); *Gordy v. Commissioner*, 36 T.C. 855 (1961).

3) The Second Circuit Court's analysis of Section 482 ignores the intent of Treas. Regs. Section 1.482-1(d)(2) and Rev. Proc. 65-17 Sections 3.02, 4.02, 1965-1 CB. 833 as to reciprocal entries required under a Section 482 allocation.

4) The denial of a tax deduction in this instance constitutes an arbitrary, unwarranted, and discriminatory application of the Commissioner's authority under Section 482 and violates Petitioners' Fifth Amendment rights. *Heiner v. Donnan, supra; Nichols v. Coolidge, supra.*

5) Because there has been an increasing use by the Commissioner of Section 482, and *because the question of a tax deduction after the application of Section 482 has never been decided by this Court*, the resolution of this issue is necessary for the proper administration of the tax laws. *U.S. v. Stapf*, 375 U.SS. 118, (1963) rehearing denied, 375 U.S. 981.

TAX COURT'S THEORY

The Tax Court rejected CCP's bad debt claim for either 1972 or 1975 on the theory that if a debt arose (from a Section 482 allocation) it did not come about until 1976 (App. D, *infra*, 40a). However, the court noted that even if there was no debt that Petitioners may be entitled to a loss, for 1976 (citing *Tharp v. Commissioner*, T.C. Memo 1972-10; *Corn Exchange Bank, supra*) (App. D, *infra*, 41a, Fn. 37).

In denying the deduction the Tax Court reasoned that the underlying tax liability as well as the interest obligation was contingent until a final decision in the *Paduano* case. (App. D, *infra*, 41a). Under the Court's reasoning, no interest should be charged by the Commissioner for the years 1967-69 except from the date the tax liability became final, in 1976; *but this is not the case.* Interest on an income tax liability or deficiency runs from the due date of the income tax returns for the years in issue. Section 6601; *Morton-Norwich Products, Inc. v. U.S.*, 602 F.2d 270 (Ct. Cl.1979). The "contingent liability" cases cited by the Court are inapposite since they do not support the position that an income tax liability becomes a fixed liability when a final decision has been rendered, although the underlying adjustments relate back to the tax years in issue.

A consistent and logical theory would hold that in Section 482 cases, the imputed interest income, interest expense, and the income tax consequences take effect simultaneously and retroactively (from the date of the final determination). The Commissioner apparently recognizes that the interest obligation arises at the same time that the interest income is imputed, because under Revenue Procedure 65-17, Section 4.02 1965-1 C.B. 833, he permits the taxpayer to issue promissory notes in payment of the interest obligation (which results from a Section 482 allocation) in order to avoid a double tax effect in certain situations. Also under Treasury Regs. Section 1.482-1(d)(2) correlative adjustments are required as to the related parties *at the time interest is imputed.*

In *Pitchford v. Commissioner*, T.C. Memo 1975-75, the Commissioner conceded, (solely for purposes of that case), that a Section 482 allocation should not be made in situations where the financial condition of the related party obligor was such that an accrual of such interest income would not have been justified on interest bearing loans involving non-related parties. By this concession, the Commissioner recognized that the

interest debt exists simultaneously with the imputation of interest.

Subsequent to the *Pitchford* case, the Tax Court, in *Hennessey v. Commissioner*, T.C. Memo 1977-122, again *considered the collectibility of an interest obligation*, and again did so for the same years in *which the Commissioner imputed the interest income*. The *Hennessy* court thus recognized that the interest income and the related interest obligation should be considered during and for the tax years in issue.

Petitioners argued in the Tax Court and on appeal that interest should not be imputed if there is no reasonable expectation of collection. The Tax Court found and the Second Circuit agreed that there was a reasonable expectation of collection. (App. A, *infra*, 7a). This holding necessarily implies that there was a pre-existing (or a simultaneous) debt which was in fact collectible.

Accordingly, it should necessarily follow that if there was an interest debt due (under Section 482) and if that interest is not collected and a tax was previously assessed, then a tax deduction should be permitted either under Section 165 (loss) or Section 166 (bad debt).

DOUBLE DEDUCTION THEORY

Notwithstanding, the Tax Court's implied admission of some tax relief to CCP for paying income tax on funds which CCP could not receive, the *Second Circuit Court under a theory which was not briefed or argued by the government*, and *on an entirely new and unprecedented theory, held that no deduction at all was permissible to CCP. That Court reasoned that petitioners were attempting to take a double deduction* because the Commissioner had already allowed an interest deduction to Stonehedge and Seneca who are not the taxpayers in this case. (App. A, *infra*, 6a) This *"double deduction" theory is incorrect as a matter of law.*

Either Stonehedge and CCP (and Seneca and CCP) are separate entities for tax purposes or they are not. If they are, and the lower Courts held so for imputing interest income, then consistency and fairness requires that they be treated as such for all tax consequences.

In denying a deduction for bad debt or business loss to CCP, the Second Circuit Court had these remarks:

> "Such a deduction was granted by the Commissioner to Seneca and Stonehedge. Thus *taxpayers seek* double deductions for Sec. 482 allocations. Neither the law nor common sense supports such an outcome." (emphasis added) (App. A, *infra*, 6a)

The appellants' position is that the Court's reasoning concerning a "double deduction" or "windfall" profits theory clearly and unfairly ignores the fact that Stonehedge and CCP and Seneca and CCP are separate entities.

Although the corporations obtained a deduction for interest expenses, *CCP received no deduction*. Stonehedge and Seneca are not the taxpayers in this case; the taxpayers before the Court are the partners (and their wives) of CCP. Consequently for the Second Circuit Court to allege a double deduction to the taxpayers, it must, of necessity, group all the corporate entities and CCP as one taxable entity. Under this reasoning, however, there would have been no Section 482 allocation made in the first place.

This Court recognized that a corporation is a separate taxable entity. *Moline Properties, Inc. v. U.S., supra*. Also, it is well settled that in determining the trade or business of a taxpayer, the business activities of a closely held corporation will not be attributed to the taxpayer absent a showing of exceptional circumstances. See, *Burnet v. Clark, supra; Jarvis v. Commissioner, supra; Gordy v. Commissioner, supra*.

The Second Circuit Court in this case as well as in its *Forman* decision (*supra*, 1972) recognized that the lender and borrower

were separate viable entities for purposes of a Section 482 imputation of interest, but when the lender attempts to claim a tax deduction on the uncollected imputed interest that court in denying the deductions inconsistently holds they are not separate entities.

Nor can it be argued that the subsequent events which allow CCP (under the tax law) to take a deduction for uncollected interest, frustrate the tax law or result in any sort of windfall or double deduction because the same principle also applies to taxpayers having net operating losses (Section 172) or capital losses (Section 1212) which are allowed to be carried back to earlier years.

The tax law also allows bad debt losses (Section 166 of the Code) and ordinary business losses. (Section 165 of the Code). These tax relief measures are allowed to non-related parties and should be allowed to related party transactions in this instance.

An example to point out the inconsistency of the double deduction theory follows:

Suppose that CCP had been on an accrual accounting basis and that it had charged interest income on the Stonehedge mortgage. At year end, CCP would have accrued interest income, and the partners would have paid income taxes on the accrued interest income. Suppose at a later date Stonehedge never having paid the accrued interest to CCP went bankrupt. Under the tax law CCP would have been entitled to take a business bad debt deduction under Section 166 of the Code.

Why should the fact that the Commissioner imputed interest income (which effectively puts CCP on an accrual basis for that purpose), to CCP under Section 482 change that result. Concerning collection of the imputed interest, the Second Circuit Court stated:

> "Had CCP wished to receive payment from the corporations reflecting the allocation of income, the

> partnership could have done so only upon application to the Commissioner and only if the Commissioner determined the interest free loans were not intended to avoid taxes. Rev. Proc. 65-17 Sections 3.02, 4.02, 1965-1 C.B.833." (App.A, *infra*, 6a)

The facts of this case make it clear, however, the Petitioners did not structure the transactions in question to avoid taxes. Most of the imputed interest involved here arose from a non-interest bearing mortgage which was transacted in 1962. This was eight years prior to the adoption of Treasury Regs. Section 1.482-2 (concerning interest free loans) and ten years prior to the *Forman* decision which upheld the Commissioner's Section 482 allocation in related party interest free loans. Before *Forman*, the law was to the contrary and no such allocation could have been made.

In fact, "Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the District Director to apply such provisions". Treas. Regs. Section 1.482-1(b)(3).

Thus assuming that Stonehedge had been in a higher tax bracket than the partners of CCP, if Stonehedge had taken an imputed interest deduction, (prior to *Forman, supra*) on the interest free mortgage (in order to reduce the overall taxes), Stonehedge and its officers would be filing fraudulent income tax returns.

It is submitted, based on the foregoing that the "double deduction" theory is illogical and contrary to established principles of law.

Compare *Mortiz v. Comm.*, 469 F.2d 466, (10 Cir. 1972) which held that an income tax deduction based on sex classification "is subject to scrutiny under equal protection principles . . . as part of due process under the Fifth Amendment." (In that case spinsters were allowed deductions for dependent care but not bachelors).

Compare also, a recent case decided by the United States Circuit Court of Appeals for the District of Columbia in which that Court struck down a law granting tax exempt status to veteran's groups but denied exemption to "other charitable and educational groups who conduct lobbying activities". That Court stated:

> "Congress has violated the equal protection guarantees of the Constitution" by granting different tax treatment to these groups. *Taxation with Representation of Washington v. Regan*, 82-IUSTC ¶9272, p. 83611 (D.C. Cir. 1982)

Neither the Commissioner nor the Second Circuit Court cited any authority to suggest that Congress intended that related parties (under Section 482 transactions) should be penalized and treated more harshly than non-related parties in similar transactions. The Second Circuit's holding in this instance is an unwarranted and unreasonable interpretation of the application of Section 482. cf. *U.S. v. Vogel Fertilizer Co., supra.*

Also, the denial of a deduction to CCP amounts to a confiscation cf. *Heiner v. Donnon, supra,* and is an obvious gross injustice. *Nichols v. Coolidge, supra.*

Based on the foregoing, it is clear that CCP was entitled to a deduction for either a business bad debt (Section 166) or an ordinary loss (Section 165) equal to the adjusted basis of the uncollected imputed interest, (Section 166(b)).

The denial of a deduction would constitute a violation of Petitioners' Fifth Amendment rights under the Due Process Clause.

REASONS FOR GRANTING CERTIORARI ON ISSUE FIVE

In denying capital gains treatment to Petitioners on their sale (through CCP) in 1962 of vacant land to Stonehedge Corporation, a related entity, the Second Circuit Court of Appeals relied on a different theory than the United States Tax Court. (App. A, *infra*, 3a, 7a, 8a) *Reisman v. Caplin, supra.*

The Tax Court did not enumerate in its findings the various factors set forth in *Gault v. Commissioner*, 332 F2 94 (2d Cir. 1964) for determining whether CCP sold the subject property to Stonehedge in the ordinary course of its business, under Section 1221(1) which are:

> "(1) the frequency, number and continuity of sales; (2) Subdivision, plotting, and other improvements or developments tending to make the property more marketable; (3) the extent to which the taxpayer is engaged in sales activity; (4) the length of time the property has been held; (5) the substantiality of the income derived from the sales, and what percentage that is of the taxpayer's total income; (6) the nature of the taxpayer's business; (7) the taxpayer's purpose in acquiring and holding the property; (8) the extent of the sales promotional activities such as advertising; (9) the listing of property directly through brokers."

332 F.2d 94 at 96.

On the contrary Judge Tannenwald of the Tax Court found that:

> *"CCP would make no efforts to improve or subdivide the parcel* but would subsequently sell it, at a profit, to Stonehedge, which . . . (would then develop the property)". (App. D, *infra*, 17a) emphasis supplied.

The Tax Court conceded that CCP and Stonehedge were separate taxable entities and that CCP's acquisition, holding and subsequent sale of the subject property was separate from

the development activities later undertaken by Stonehedge. Nevertheless, the Tax Court held, that:

> "CCP can not be permitted to insulate itself from the acts of an entity (Stonehedge) whose efforts are so closely related to its own; the supplier of developable land may be regarded as a joint participant with the builder in an integrated real estate development business." (Citations omitted). (App. D, *infra*, 43a)

The Tax Court concluded that CCP and Stonehedge were "joint participants" in a real estate development venture and that CCP was, therefore, "in the trade or business of land development and sales at the time the Seneca Knolls properties were sold." (App. D, *infra*, 44a).

It is well settled that in determining the trade or business of a taxpayer, the business activities of a closely held corporation will not be attributed to the taxpayer absent a showing of exceptional circumstances. See, *Burnet v. Clark, supra; Jarvis v. Commissioner, supra; Gordy v. Commissioner, supra.*

In *Gordy, (supra)*, the Tax Court considered facts similar to those in the case at bar and held that the taxpayer's gain on the sale of land to a controlled corporation in the real estate development business constituted capital gain and not ordinary income. The Tax Court in *Gordy* stated:

> "Respondent recognizes no distinction between a taxpayer holding property for sale to his customers and a taxpayer holding property for sale to his controlled corporation engaged in selling such property to its customers."

36 T.C. 855 at 859-860. The *Gordy* Court, citing *Burnet v. Clark, (supra)*, held, that the taxpayer's business and the business of the real estate development corporation were separate and distinct and that, as long as the corporation was a viable entity and could not be regarded as the taxpayer's alter

ego or agent, the corporation's development activities could not be attributed to the taxpayer.

It is undisputed that throughout the years in question Stonehedge was a viable business entity and in no sense the alter ego of CCP. *The primary point of contention here thus concerns the Tax Court's finding that Stonehedge's activities could be imputed to CCP because the entities were engaged in a joint venture.* The cases cited by the Tax Court in support of this finding are clearly distinguishable from the case at bar both in principle and on the facts. This is supported by the fact that neither the government in its argument to the Second Circuit Court, nor that Court itself, relied on the Tax Court's joint venture theory. (App. A, *infra*, 8a).

If the Tax Court on the facts presented could have found CCP a developer based on CCP's own activities (and not the activities of Stonehedge), it would seem unreasonable and unwarranted for that Court also to rely on the joint venture theory. Since the trial Judge did not, on the facts pertaining to CCP alone, hold that CCP was a developer, and since the facts pertaining to the lack of CCP's development activity and lack of significant sales activity were not clearly in dispute, it is submitted that the Second Circuit Court's holding was not justified by the facts and is erroneous.

CONCLUSION

The petition for writ of certiorari should be granted.

VICTOR CHINI, ESQ.
Attorney for Petitioners

Stanley Germain, Jr., Esq.
of Counsel

Dated: April 1982

APPENDIX A
OPINION OF U.S. COURT OF APPEALS FOR THE SECOND CIRCUIT

UNITED STATES COURT OF APPEALS
For the Second Circuit

No. 101—August Term, 1981

(Argued: September 28, 1981 Decided: December 29, 1981)

Docket No. 80-4244

GRACE CAPPUCCILLI, ET AL.,

Petitioners-Appellants,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Before:

LUMBARD and VAN GRAAFEILAND, *Circuit Judges*
and BONSAL, *District Judge.**

Grace Cappuccilli, Dorothy Cappuccilli, Gerald Paduano and Caroline Paduano appeal from a decision in the United States Tax Court, Tannenwald, *J.*, upholding the Commissioner's determinations that (1) petitioners' partnership recognized ordinary income, not capital gain, from the sale of real property; (2) income should be allocated from petitioners' corporations to their partnership for the years 1970-72; (3) a

*Honorable Dudley B. Bonsal, United States District Judge for the Southern District of New York, sitting by designation.

deduction should be denied for income allocated to but never collected by the partnership for 1967-69.

Affirmed.

VICTOR CHINI, ESQ., Syracuse, New York (Stanley R. Germain, Esq., Syracuse, New York, of counsel), *for Petitioners-Appellants.*

R. RUSSELL MATHER, Attorney, Tax Division, Department of Justice, Washington, D.C. (John F. Murray, Acting Assistant Attorney General, Michael L. Paup, Daniel F. Ross, Attorneys, Tax Division, Department of Justice, Washington, D.C., of counsel), *for Appellee.*

LUMBARD, *Circuit Judge:*

Dorothy Cappuccilli, Grace Cappuccilli, Gerald Paduano and Caroline Paduano appeal from a decision of the Tax Court, Tannenwald, *J.*, sustaining income tax deficiencies asserted by the Commissioner for 1970-72, and denying a refund sought by the taxpayers for 1967-69.[1] Some of the deficiencies were based on income from the sale of land by the taxpayers' partnership Cappuccilli, Cappuccilli and Paduano (CCP), which the taxpayers reported as a capital gain and the Commissioner taxed as ordinary income. Other deficiencies

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[1]The Commissioner assessed deficiencies of $7,140.13 for 1970, $7,089.58 for 1971, and $69,974.26 for 1972 against Grace Cappuccilli; $7,422.54, $7,467.60 and $71,077.22 for those years against Dorothy Cappuccilli; and $7,590.10, $6,486.68 and $59,895.65 for those years against Gerald and Caroline Paduano. The three taxpayers sought a refund for 1967-69 totalling $201,633.73.

were based on allocation of income under § 482 of the Internal Revenue Code to the partnership from corporations controlled by the partners. The corporations never made case payments to CCP corresponding to the income allocated by the Commissioner. The taxpayers claim that it was improper to allocate corporate income to the partnership in 1970-72, and that, in any event, the partnership should have an offsetting deduction. The taxpayers further claim a refund for 1967-69 on similar grounds: that corporate income allocated to the partnership in those years was never paid. We affirm the judgment of the Tax Court and sustain the Commissioner, although not entirely for the reasons enunciated by Judge Tannenwald.

The facts were stipulated by the parties or found at trial by Judge Tannenwald, and taxpayers dispute few of those findings on appeal. Brothers Peter and Rocco Cappuccilli and Gerald Paduano each own one third of the partnership bearing their names. (All filed joint tax returns, but as Peter and Rocco filed bankruptcy petitions in 1977, the deficiencies were assessed against their wive.) Their partnership, CCP, bought undeveloped land in the Syracuse, New York area, and sold it on credit, at a paper profit, to Stonehedge Development Corporation, which in turn contracted for development work with Seneca Sewerage Corporation. Each CCP partner owned one third of these corporations until 1969, when Paduano retired and sold his shares to the Cappuccilli brothers. CCP and Stonehedge operated out of the same offices. CCP, Stonehedge, Seneca and the individual partners all used the same lawyer.

Starting in 1955, Stonehedge developed the Seneca Knolls Community in the town of Van Buren, New York. From 1961 to 1962, CCP purchased land adjoining Seneca Knolls — hereinafter the Seneca Farms — for a total of $445,723 and resold it to Stonehedge for a total of $1,570,327.39 — consisting of assumption of mortgages, cash and two promissory

notes, one for $81,000 yielding six percent interest, and one non-interest bearing note for $1,075,000. On April 15, 1961, CCP purchased a different plot of land from Stonehedge — the Preston Farm — for $25,000, and resold it the next day to Seneca for $40,000 — which included a $25,000 promissory note intended to yield six percent. The corporations made payments of principal, but no payments of interest. The Commissioner concluded that the lack of interest recognized by CCP on the notes to the controlled corporations understated the true income of the partnership. Interest income of $325,718.90 was allocated to CCP for 1967-69. At the same time, the Commissioner credited the affiliated corporations with a deduction for interest paid to CCP. The allocation was upheld in *Paduano v. Commissioner*, 34 T.C.M. (CCH) 368 (1975), *aff'd mem.*, 538 F.2d 312 (2d Cir.), *cert. denied*, 425 U.S. 992 (1976).

Zoning problems prevented Stonehedge from developing the land. From 1970 to 1975, Stonehedge was insolvent. In 1970, Stonehedge borrowed $500,000 from Merchants National Bank & Trust Co. on the security of a pending eminent domain claim against New York State, and in 1972 the corporation sold land for $223,756, paying the proceeds to CCP. But from 1970 to 1972, CCP had to advance cash to Stonehedge to keep the corporation going. Stonehedge's debt to CCP for these advances once totalled $120,000. Stonehedge managed to repay these advances, but never paid any interest on them. In 1972, Stonehedge reconveyed part of the Seneca Farms to CCP and CCP foreclosed on the remainder, in full satisfaction of Stonehedge's obligations to the partnership. Because CCP had received payments on the notes while Stonehedge was in possession of the land, CCP recognized gain to the extent of those payments — $482,577 — upon repossession under I.R.C. § 1038. CCP reported this gain as capital gain.

APPENDIX A
Opinion of U.S. Court of Appeals for the Second Circuit

In 1975, Stonehedge merged with Community Technology, Inc. (CTI), which filed a Chapter XI bankruptcy petition in 1976. CCP filed a claim for $325,718.90 in interest income from Stonehedge as allocated by the Commissioner as CTI's predecessor to CCP, but the bankruptcy court, McGuire, *J.*, (W.D.N.Y.), held that under New York law, the Commissioner's allocation imposed no obligation on CTI to pay interest to CCP.[2]

The Cappuccillis and Paduanos sought a bad debt deduction corresponding to the 1967-69 allocated interest, and therefore claimed a refund. The Commissioner denied the 1967-69 deduction and the refund, and allocated $132,088.70 in interest income from the controlled corporations to CCP for 1970-72. The Commissioner again credited the controlled corporations with a deduction for interest allocated to CCP. The Commissioner further asserted that CCP's gain on repossession of land from Stonehedge was ordinary income, not capital gain. The Tax Court sustained the Commissioner's determinations, and this appeal followed.

The taxpayer's claim for either a bad debt deduction or an ordinary loss deduction is unprecedented, and, we think, unwarranted. Section 482 empowers the Commissioner to allocate income among mutually controlled organizations to reflect their true income. Interest free loans are often used to shift income from organizations with high tax liabilities to those with low tax liabilities. *Latham Park Manor, Inv. v. Commissioner*, 69 T.C. 199, 212 (1977), *aff'd mem.*, 618 F.2d 100 (4th Cir. 1980). The Commissioner here merely determined that CCP's income was understated, and that, as a result, the income of Stonehedge or Seneca was overstated. He placed no

[2]CTI emerged from bankruptcy court in 1977, when a plan of arrangement was approved providing for 100 percent payment of unsecured claims over seven years, and for the subordination of individual Cappuccilli claims.

obligation on the corporations to pay the partnership. Had CCP wished to receive payments from the corporations reflecting the allocation of income, the partnership could have done so only upon application to the Commissioner and only if the Commissioner determined the interest free loans were not intended to avoid taxes. Rev. Proc. 65-17, §§ 3.02, 4.02, 1965-1 C.B. 833. To allow CCP a deduction now would retroactively cancel the Commissioner's determination of CCP's true tax status in 1967-72. Granting such a deduction could also give taxpayers a windfall. Allocation of income under § 482 is properly offset by the creation of a deduction for the organization from which income was allocated. *B. Forman Co. v. Commissioner*, 453 F.2d 1144, 1156 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972); Treas. Reg. § 1.482-1(d)(2). Such a deduction was granted by the Commissioner to Seneca and Stonehedge.[3] Thus taxpayers seek double deductions for § 482 allocations. Neither the law nor common sense supports such an outcome.[4]

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[3]The offsetting deductions granted under Treas. Reg. §1.482-1(d)(2) to Seneca and Stonehedge may be unused if the corporations' successor, CTI, fails to earn income against which the deduction can be applied. But the fact that a §1.482-1(d)(2) deduction is worthless or unavailable does not preclude allocation of income under §482, *Continental Equities, Inc. v. Commissioner*, 551 F.2d 74, 78-82 (5th Cir. 1977), and therefore is no reason to void such allocation retroactively by granting CCP a deduction.

[4]Judge Tannenwald ruled that any "bad debt" corresponding to a §482 allocation existed only after the Supreme Court had denied certiorari in 1976 — and therefore the taxpayers' assertion of a 1976 deduction was not timely for offsetting taxes paid 1967-69. Given our analysis of the "bad debt" deduction, we need not reach the issue of timeliness. We would note, however, that the analysis of the tax court would preclude direct appeal of taxpayers' claim for a "bad debt" deduction for 1970-72. The Supreme Court would have to deny certiorari on the decision herein on the §482 allocation for 1970-72 before we could consider any offsetting "bad debt" deduction based on that allocation. The tax court did not consider taxpayers' claims for a bad debt deduction for 1970-72.

APPENDIX A
Opinion of U.S. Court of Appeals for the Second Circuit

The taxpayers argue that the allocation of income to CCP for 1970-72 was improper, either because CCP had no reasonable expectation of receiving interest from the corporations or because Gerald Paduano's sale of stock in the corporations dissolved the common control of CCP and the corporations. In both instances, taxpayers challenge findings of fact by the tax court. In neither instance are the findings clearly erroneous. Judge Tannenwald's finding that CCP did have a reasonable expectation of receiving interest was based on Stonehedge's receipt of a $500,000 loan from Merchants National Bank & Trust Co., on Stonehedge's sale of land to a third party for $233,756, and on Stonehedge's ability to repay CCP for its cash advances. Judge Tannenwald further found that common control of CCP and the corporations existed in 1970-72 because the interest-free notes represented a common control method of income shifting that predated Paduano's retirement and continued afterwards. This finding comports with the rule in this circuit that the realities of control, rather than record ownership, determine the application of § 482. *B. Forman Co., supra,* 453 F.2d at 1153-4. If the owners of one organization differ from the owners of another, the two may still be held to be under common control if they are in fact run by the same people. *Collins Electrical Co., Inc. v. Commissioner,* 67 T.C. 911, 918-19 (1977) Clearly, the Cappuccilli brothers ran CCP, Seneca and Stonehedge.

There remains the question of whether CCP's gain on repossession of Stonehedge's land was capital gain or ordinary income. The character of gain on repossession under § 1038 is determined by the character of the original sale. Treas. Reg. § 1.1038-1(d). Therefore the question is whether CCP in 1962 sold land in the ordinary course of business. I.R.C. § 1221(1). Two decades ago, the IRS taxed CCP's gain from the sale of land in 1957-58 as the sale of ordinary assets yielding ordinary income. CCP did not challenge the IRS. Now the Com-

missioner again asserts that CCP was, during 1961-62, in the business of buying and selling real estate. CCP assembled the Seneca Farms in purchases from February 22, 1961 through January 3, 1962. CCP drew up papers for resale of the land in late 1961 and early 1962. The closing was to occur on January 10, 1962, only a week after the last of the farms had been purchased. The closing was delayed until December 28, 1962 only because the partners became concerned about rezoning the land for development. The gains from this turnover of real estate were clearly " 'the profits and losses arising from the everyday operation of a business' " rather than " 'the realization of appeciation in value accrued over a substantial period of time,' " *Malat v. Riddell*, 383 U.S. 569, 572 (1966). Petitioners' only evidence to the contrary was the assertion by Peter Cappuccilli that CCP purchased the land for either speculation or investment. On this record, such an assertion is insufficient to carry petitioners' burden of proof in challenging the Commissioner's determination that CCP's gain was ordinary income.[5]

Affirmed.

VAN GRAAFEILAND, *Circuit Judge*, Concurring:

Because appellants' attorneys have proceeded in this matter as if their clients' interests were identical, I concur in the result reached by my colleagues. Had counsel seen fit to distinguish the merits of the Paduano claim from those of the other appellants, I would find affirmance of that claim more troublesome.

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[5] Judge Tannenwald found that the interrelationships between CCP, Stonehedge and their owners created a "joint venture" of sorts. As taxpayers conceded that Stonehedge was in the business of buying and selling real estate, Judge Tannenwald ruled that CCP as a joint venturer was, through Stonehedge, also in the business of buying and selling real estate. Given our analysis of CCP's business, we need not consider the joint venture theory enunciated by the tax court.

APPENDIX A
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In May 1969, Mr. Paduano relinquished all of his interest in Stonehedge Development Corporation and Seneca Sewerage Corporation. The only evidence presented in the Tax Court indicated that, although Paduano remained a nominal partner in CCP, he in fact retired from active participation in that partnership. Despite these undisputed facts, Mr. and Mrs. Paduano have been held liable to pay a tax on non-existent income allocated from the corporations to the partnership and which, of course, the Paduanos never received.

When actual partnership income is involved, the law is clear that each partner must pay a tax on his distributive portion of that income. *United States v. Basye*, 410 U.S. 441, 448 (1973). However, "[t]hat which is not in fact the taxpayer's income cannot be made such by calling it income." *Hoeper v. Tax Commissioner*, 284 U.S. 206, 215 (1931). Taxable income contemplates the existence of an economic benefit which is subject to the dominion and control of the taxpayer. *Commissioner v. Kowalski*, 434 U.S. 77, 83 (1977); *Commissioner v. First Security Bank*, 405 U.S. 394, 403 (1972). Because the Paduanos had no interest in or control over the corporations during the taxable years in question and derived no benefit whatever from the interest-free loans to those entities, the allocation of income from the corporations to the Paduanos has constitutional implications which are bothersome. Although courts look upon tax legislation with an indulgent eye, a levy which is so arbitrary and capricious as to amount to confiscation may be held to violate the Fifth Amendment. *Heiner v. Donnan*, 285 U.S. 312, 326 (1932); *Nichols v. Coolidge*, 274 U.S. 531, 542 (1927).

Because this issue has been neither briefed nor argued, I discuss it only to indicate my belief that the Commissioner's power of allocation under section 482 is not without constitutional limitations.

APPENDIX A
Opinion of U.S. Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS
Second Circuit
United States Court House
Foley Square
New York 10007

A. DANIEL FUSARO
Clerk

Grace Cappuccilli, et al. v. C.I.R. August Term, 1981
Docket No. 80-4244 Decided December 19, 1981

Page 612, line 26 — delete "case payments" and insert "cash payments" in place thereof.

Page 614, line 3— delete "affiliated".

Page 614, lines 28 and 29 and 30 — delete entirely and insert "1976, CCP filed a claim for $325,718.90 in interest allocated by the Commissioner from Stonehedge to CPP, but the bankruptcy court, McGuire, *B.J.*," in place thereof.

Page 614, line 32 — delete "on CTI" and insert "on Seneca or its successor CTI" in place thereof.

A. DANIEL FUSARO, Clerk

ADF/hjd

APPENDIX B
ORDER OF U.S. COURT OF APPEALS FOR THE SECOND CIRCUIT DENYING REHEARING

UNITED STATES COURT OF APPEALS
Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the 27th day of January, one thousand nine hundred and eighty-two.

Present: HON. J. EDWARD LUMBARD, HON. ELLSWORTH A. VanGRAAFEILAND, *Circuit Judges,* HON. DUDLEY B. BONSAL, *District Judge.*

GRACE CAPPUCCILLI, DOROTHY CAPPUCCILLI, GERALD F. PADUANO and CAROLINE PADUANO,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Docket No. 80-4244

A petition for a rehearing having been filed herein by counsel for the petitioners-appellants, Grace Cappuccilli, et al.,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

A. DANIEL FUSARO
Clerk

by: /s/ FRANCIS X. GINDHART
Francis X. Gindhart
Chief Deputy Clerk

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT
FILED
JAN 27 1982
A. DANIEL FUSARO, Clerk

APPENDIX C
JUDGMENT OF U.S. COURT OF APPEALS FOR THE SECOND CIRCUIT

UNITED STATES COURT OF APPEALS
For The Second Circuit

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-ninth day of December one thousand nine hundred and eighty-one.

Present:

HON. J. EDWARD LUMBARD,
HON. ELLSWORTH A. VAN GRAAFEILAND
Circuit Judges

HON. DUDLEY B. BONSAL,
District Judge

GRACE CAPPUCCILLI, et al.,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Docket No. 80-4244

Appeal from the United States Tax Court

This cause came on to be heard on the transcript of record from the United States Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the decision of said United States Tax Court be and it hereby is affirmed in accordance

APPENDIX C
Judgment of U.S. Court of Appeals for the Second Circuit

with the opinion of this court with costs to be taxed against the appellant.

A. DANIEL FUSARO
Clerk

by /s/ EDWARD J. GUARDARO,
Edward J. Guardaro,
Deputy Clerk

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT
FILED
DEC 29 1981
A. DANIEL FUSARO, CLERK

APPENDIX D
OPINION OF UNITED STATES TAX COURT

T. C. Memo. 1980-347

UNITED STATES TAX COURT

GRACE CAPPUCCILLI, ET AL.,[1] Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 2095-77, 2097-77, 2207-77, 2208-77, 5255-77, 5801-77.

Filed August 28, 1980.

SERVED AUG 28 1980

Victor Chini, for the petitioners.

Kenneth Bersani and *John D. Steele, Jr.*, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

TANNENWALD, *Judge:* In these consolidated cases, respondent has determined deficiencies against petitioners for the taxable years 1970, 1971. and 1972 as follows:

Petitioner	Docket No.	Year	Deficiency
Grace Cappuccilli	2095-77	1970	$ 7,140.13
		1971	7,089.58
	2208-77	1972	69,974.26
Dorothy Cappuccilli	2097-77	1970	7,422.54
		1971	7,467.60
	2207-77	1972	71,077.22
Gerald F. and Caroline Paduano	5801-77	1970	7,590.10
		1971	6,486.68
	5255-77	1972	59,895.65

[1] Cases of the following petitioners are consolidated herewith: Dorothy Cappuccilli, docket Nos. 2097-77 and 2207-77; Grace Cappuccilli, docket No. 2208-77; and Gerald F. and Caroline Paduano, docket Nos. 5255-77, 5801-77.

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The tax year 1975 is also involved for all of the petitioners because of, and to the extent of, a disputed bad debt deduction which resulted in a claimed loss carryback to 1972.[2]

The issues presented in these cases are: (1) whether respondent properly allocated interest for the years 1970, 1971, and 1972 under section 482[3] to the partnership of Cappuccilli, Cappuccilli, & Paduano (CCP or the partnership) from two related corporations on account of mortgage notes held and cash loans made by CCP; (2) whether interest income properly allocated to CCP under section 482 on account of the above-mentioned mortgages and cash loans in 1967, 1968, and 1969 (see *Paduano v. Commissioner,* T.C. Memo. 1975-69, affd. mem. 538 F.2d 312 (2d Cir. 1976), cert. denied 425 U.S. 992 (1976)), may be the subject of a bad debt deduction in either 1972 or 1975; (3) whether the gain which CCP realized pursuant to section 1038, because of its foreclosure of a mortgage in 1972, is ordinary or capital in nature, and, if capital, whether it is long or short term.

FINDINGS OF FACT

Some of the facts were stipulated. The stipulations of facts and stipulated exhibits are incorporated herein by this reference.

At the time the petitions herein were filed, Grace Cappuccilli (Grace) and Dorothy Cappuccilli (Dorothy) resided in

[2] In his preliminary statement on brief, respondent states that these consolidated cases are also for the redetermination of an overpayment of income tax of the petitioners for 1975 in the following amounts: Grace Cappuccilli, $1,460; Dorothy Cappuccilli, $2,815; and Gerald F. and Caroline Paduano, $1,072.

[3] All section references, unless otherwise indicated, are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years at issue.

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Syracuse, New York, and Gerald F. Paduano (Paduano) and Caroline Paduano resided in Sarasota, Florida. Grace, with her husband Peter L. Cappuccilli (Peter), who is not a party to these cases, timely filed joint income tax returns with the North Atlantic Service Center, Andover, Massachusetts, for the taxable years 1970, 1971, and 1972, as did Dorothy and her husband Rocco M. Cappuccilli (Rocco), who is also not a party to these cases, and the Paduanos.

On May 6, 1976, Peter and Rocco each filed separate petitions with the United States District Court for the Northern District of New York, pursuant to Chapter XII of the Bankruptcy Act. Pursuant to section 6871, the District Director of Internal Revenue, Buffalo, New York, assessed income tax deficiencies for the taxable years 1970, 1971, and 1972 against both Peter and Rocco. The deficiencies which were assessed against them are the deficiencies which are the subject of their wives' petitions herein.

In 1954, Peter, Rocco, and Paduano (hereinafter collectively referred to as the developers) formed CCP. Each had a one-third interest in the partnership. CCP was principally engaged in the real estate business in the Syracuse, New York, area. Stonehedge Development Corporation (Stonehedge) was organized on April 8, 1953. The stock of Stonehedge was owned equally by Peter, Rocco, and Paduano from its organization through May 26, 1969. Seneca Sewerage Corporation (Seneca) was organized on April 1, 1961, for the purpose of operating a sanitary sewage treatment plant. The stock of Seneca was owned equally by Peter, Rocco, and Paduano through May 26, 1969. On May 27, 1969, Paduano retired from active participation and ownership in all the corporate and business ventures they had undertaken together, except with respect to the partnership. Subsequently, in 1969, and in all of 1970, 1971, and 1972, the stock of Stonehedge was

owned equally by Peter and Rocco, as was the stock of Seneca. The partnership ownership interests remained the same, although Paduano did not take an active part in the operations of CCP.

The general plan of the developers was to have CCP acquire options and purchase individual properties until it had put together a parcel of land which could be developed; CCP would make no efforts to improve or subdivide the parcel but would subsequently sell it, at a profit, to Stonehedge, which would make the necessary improvements, obtain new zoning (if necessary), subdivide the lots, and construct and sell houses or other buildings. The proceeds from these sales would provide Stonehedge with the necessary funds to discharge the obligations which it incurred in acquiring the land from CCP.

CCP also owned other properties for investment purposes, such as a bowling alley, an office building, and other rental properties.

Between 1955 and 1962, Stonehedge developed a community known as Seneca Knolls in the Town of Van Buren, New York. Henderson farm, lying adjacent to Seneca Knolls, was purchased by CCP on March 8, 1960, for $125,460. The farm was sold to Stonehedge on February 20, 1961, in consideration of a cash payment of $28,122.25, the assumption of mortgage obligations totaling $107,605.14, and a note in the amount of $81,000, bearing interest at six percent per annum, secured by a purchase money mortgage, and providing for payment of principal to be made in equal installments plus interest on the first and second anniversaries of the sale.

During the period February 22, 1961, through January 3, 1962, CCP acquired five contiguous farms (hereinafter the

Seneca Knolls farms) at a total cost of $320,083.[4] The Seneca Knolls farms lay between two previously completed sections of the Seneca Knolls community. CCP anticipated that the Seneca Knolls farms would be sold to Stonehedge (or another developer) who would then subdivide them into lots for individual sale.

Prior to purchasing the Seneca Knolls farms, however, Stonehedge wanted to be relatively certain that the Town of Van Buren would rezone the land for residential lots of the size they desired. Peter and Rocco had contacts with various town officials and were given conflicting signals regarding the zoning request. Nonetheless, in late 1961 and early 1962, their lawyer, James M. Cerio,[5] drafted the necessary documents for the Seneca Knolls farms to be transferred to Stonehedge. Cerio brought these documents — a closing statement, mortgage note, mortgage, and the deed — with him to a meeting at the developers' offices on January 10, 1962. At that meeting, Peter signed the closing statement, note, mortgage, and deed as president of Stonehedge; Peter, Rocco, and Paduano all signed the deed. During the meeting, while signing the documents, the parties realized that there was a serious question whether the zoning request, with negotiated modifications, would be ap-

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[4]

Farm	Date of Purchase	Purchase Price	Existing Mortgage	Interest per annum
Walter	2/22/61	$ 64,065	$54,000	4 percent
Commane	10/20/61	71,830	51,830	5 percent
Green	10/26/61	34,788	24,690	5½ percent
Patterson	11/24/61	22,400	18,650	0 percent
Higgins	1/ 3/62	127,000	84,000	5 percent
			42,000	5 percent (Hunt)

[5]Cerio was the attorney for CCP, Stonehedge, and Seneca, as well as Peter, Rocco, and Paduano.

proved. Consequently, the individuals held up signing the closing statement and concluding the sale until they were reasonably satisfied that the zoning problem would be resolved. Cerio left and Peter placed the documents in the CCP files in the office.[6] CCP paid the real estate tax on the properties for 1962.

On December 28, 1962, another meeting was held to close the sale. Checks were written to cover transfer and recording fees, legal fees, and the cash balance due CCP according to the closing statement. Cerio recorded the deed later that day; when the deed was returned after the recording, it was placed in the Stonehedge file. Stonehedge made no payments on the purchase between January 10 and December 28, 1962. The total purchase price for the farms was $1,353,600. Stonehedge was to assume mortgages on the land (from CCP's purchases) totaling $275,170. In addition, it gave CCP a mortgage and non-interest bearing note for $1,075,000 to be paid $75,000 on January 10, 1964, and $100,000 on each successive January 10 until the balance was paid in full. The deed, note, and mortgage retained the January 10, 1962, date reflected in the documents originally prepared for the sale.

After the January 10, 1962, meeting, Stonehedge continued its attempts to get the zoning change. In an application to the Planning Board of the Town of Van Buren in June 1962, Stonehedge stated that the land was "now owned by deed or contract by Stonehedge," and that "[p]rior to development, complete title by deed will be held by the Corporation." Its petition to the Town Board merely made the former statement as did Cerio in his appearance for Stonehedge at an August 16, 1962, hearing on the application.[7] Cerio's presentation, as well as the

[6] CCP and Stonehedge were both operated out of the same office, as were various other enterprises of the Cappucillis and Paduano.

[7] No separate contract of sale of the farms to Stonehedge is in evidence.

petition to the board, explained that the development planned on the parcel was "in conformity with the developer's master plan of development conceived and laid out prior to the enactment of the present zoning ordinances [in 1961]."

The Town Board refused Stonehedge's request, so Stonehedge brought an action to compel approval of the rezoning request in August 1963. In its complaint, Stonehedge stated that it "is and at all times hereinafter mentioned was the owner of [the Seneca Knolls farms];" that period included the summer of 1962, during which time the rezoning applications were pending.

During all of the taxable years 1970 and 1971, and during the period from January 1 until March 13, 1972, CCP carried two mortgage receivables on its books and records due from Stonehedge. These mortgages resulted from the sale of the Henderson farm and the Seneca Knolls farms by CCP to Stonehedge. The outstanding balances on these two mortgages on various relevant dates were as follows:

Date	Henderson Farm	Seneca Knolls Farms
Date of purchase	$81,000	$1,075,000
1/ 1/70	70,000	1,052,850
12/31/70	70,000	1,052,850
1/ 1/71	70,000	1,052,850
12/31/71	70,000	1,052,850
1/ 1/72	—[8]	1,010,972[9]
3/12/72	—	1,010,972

During the taxable years 1970, 1971, and 1972, CCP carried a mortgage receivable on its books and records due from

[8]These figures are not available in the record.

[9]There is no explanation in the record as to how the mortgage balance went from $1,052,850 on 12/31/71 to $1,010,972 on 1/1/72, only one day later.

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Seneca in the amount of $25,000.[10] This mortgage resulted from the sale of half the Preston farm (20 acres) by CCP to Seneca on April 16, 1961. The Preston Farm was purchased on April 15, 1961, by CCP from Stonehedge.

Neither Stonehedge nor Seneca paid CCP any interest on their respective mortgages during the taxable years 1970, 1971, or 1972. Due to Stonehedge's development problems, Seneca was unable to realize revenue from anticipated tap-ins.

During the taxable years 1970, 1971, and 1972, CCP had loans due from Stonehedge (in addition to the mortgage loans discussed *supra*) on which no interest was charged or paid in the following amounts:

1970			
			Balance
	Balance 1/1/70		$120,000
	Balance 12/31/70	(repaid 10/29/70)	0
1971			
	Balance 1/1/71		0
	Advance 6/21/71	$6,000	$ 6,000
	Advance 7/20/71	6,000	12,000
	Advance 8/10/71	4,000	16,000
	Advance 10/23/71	4,000	20,000
	Advance 11/24/71	3,000	23,000
	Balance 12/31/71		23,000
1972			**Balance**
	Balance 1/1/72		$23,000
	Balance 12/31/72		23,000

[10] It is not clear from the record whether this note bore interest, or at what rate, because the exhibit which the parties stipulated to be the note is, in fact, the mortgage note from Stonehedge to CCP on the Henderson farm. Petitioners' brief indicates the note called for six percent interest, as does the testimony.

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These loans resulted from advances to Stonehedge in order to keep the corporation going and to meet priority obligations on first mortgages.

On or about November 12, 1968, the State of New York acquired by eminent domain a portion of the Seneca Knolls farms property. Stonehedge rejected the state's offer of $52,300 for the property (on which a partial payment had been made in 1969). The condemned property had a cost basis of $130,183. On January 26, 1970, Stonehedge filed a claim against the State of New York for $2,000,000; $1,000,000 in direct damages and $1,000,000 consequential damages. It expected to realize $600,000 to $700,000 on this claim. By judgment entered May 16, 1973, the Court of Claims of the State of New York determined that Stonehedge was entitled to $245,399 for the parcel taken by the State. The total amount paid Stonehedge, including interest, was $294,032.91, of which $39,225 had been received as a partial payment in 1969.

In 1970, Stonehedge assigned its anticipated award from the State as security for a $500,000 loan to be used to develop land in Van Buren from the Merchants National Bank and Trust Company of Syracuse (Merchants Bank). The loan was also secured by mortgages on two farms and the personal guarantees of Peter and Rocco, which Merchants had considered insufficient collateral without the assignment of the claim against the State. Interest was payable at 1-1/2 percent over the prime rate. Merchants Bank made this loan, in part, in anticipation of receiving mortgage applications from the purchasers of units from Stonehedge and its affiliated corporations. Had it known, however, that only $254,807.91 would be received from the State for the assigned claim, it probably would not have made the loan.

Prior to the pledge of Stonehedge's potential claim against the State to Merchants Bank, it was not otherwise pledged, assigned, or made the subject of a security interest.

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On March 14, 1972, Stonehedge sold approximately 115 acres of land in the Seneca Knolls farms tract and paid CCP the $223,756 proceeds of the sale.[11] This money was used to reduce the principal of CCP's mortgage on the property (the partial release of which was a precondition to the sale), after which $889,094 of mortgage principal remained outstanding.

On or about March 14, 1972, Stonehedge gave CCP a deed in lieu of foreclosure of the CCP mortgages for the Henderson farm and the remainder of the Seneca Knolls tract. CCP took ownership of the properties in full satisfaction of its mortgages. CCP realized a gain of $482,577 on its reacquisition of the properties from Stonehedge.

Stonehedge's balance sheets for the years ending December 31, 1970, 1971, and 1972 reflected the following:

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[11] The two purchasers, PRG Enterprises, Inc., and the Village Green of Van Buren, Inc., were corporations related to Stonehedge and CCP. The date of March 14, 1972, is stipulated by the parties, although the foreclosure document states that these two entities were conveyed land in deeds dated December 30, 1971.

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	1970	1971	1972	1973	1974
ASSETS					
Current assets	$ 303,836[12]	$ 16,230	$ 13,285	$	$
Equipment (less depreciation)	4,995	3,496	26,145		
Land (at cost)	1,338,654	1,338,797	200,175		
Due from Seneca	71,950	68,950	69,350		
Seneca mortgage	10,000	10,000	10,000		
Total Assets	$1,729,435	$1,437,473	$318,955	$4,819	$5,118
LIABILITIES AND STOCKHOLDERS' EQUITY					
Current liabilities	$ 90,174	$ 116,348	$174,500		
Mortgages payable	1,146,152	1,142,101	9,249		
Merchants' Bank loan	496,000[13]	472,000[14]	306,000		
Other liabilities	57,416	66,385	90,397	15,908	15,847
Common stock[15]	8,357[15]	8,357[15]	8,357[15]	8,357[15]	8,357[15]
Retained earnings	(68,664)	(367,718)	(269,548)	(19,446)	(19,086)
Total Liabilities and Stockholders' Equity	$1,729,435	$1,437,473	$318,955	$4,819	$5,118

[12]This includes $250,000 due from two affiliated companies, Stevemark Realty Corp. and Cappy's of Syracuse, Inc., of which $240,324 was written off as uncollectible in 1971.

[13]Of this amount, $104,000 was due within one year.

[14]Of this amount, $24,000 was due within one year.

[15]Stonehedge originally issued at par 180 out of 200 authorized shares of $100 par value common stock. Paduano's shares were purchased by the corporation in 1969 for $9,643.22 and held as treasury stock. It is the net of these figures, $8,357, which is reflected as shareholders' equity in common stock.

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The following table shows Stonehedge's earnings during the taxable years indicated as shown on its financial statements and/or tax returns:[16]

Year	Gross profit or loss from sales	Other Income	Net earnings (or loss) after provision for taxes
1967	$40,341.95	$ 4,216	$ 3,285
1968	(26,683.23)	6,269	(54,687)
1969	No sales listed	6,113	(35,948)
1970	No sales listed	1,175	(43,645)
1971	No sales listed	2,321	(299,054)
1972	No sales listed	1,245	(39,563)[17]
1973	No sales listed	254,708[18]	9,779
1974	No sales listed	86	(125)

The notes to the 1970 and 1971 financial statements' schedules of land and mortgages payable, referring to the Seneca Knolls farms, state: "It is the opinion of management that the market value of the land exceeds the stated amount of each mortgage."

For the taxable years 1967, 1968, and 1969, the District Director of Internal Revenue, Buffalo, New York, allocated interest on the mortgages given CCP by Stonehedge and Seneca, and on advances made by CCP to Stonehedge and to Cappy's Real Estate, Inc., another related corporation, pursuant to section 482. In 1975, this Court sustained respondent's allocation of interest, and its effect on the distributable part-

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[16] For 1973, the financial statement covers only the five-month period ending May 31, whereas the tax return covers the entire year.

[17] The statement of earnings reflects a capital gain of $137,733.16, presumably from the foreclosure, which, under the circumstances, represents no cash receipts.

[18] Includes $48,634 in interest in respect of the condemnation award and $204,224 reported as long-term gain, the source of which was not identified.

nership income of each of the partners, for those three taxable years. Our decision was affirmed by the United States Court of Appeals for the Second Circuit, and the Supreme Court denied certiorari. *Paduana v. Commissioner*, T.C. Memo. 1975-69, affd. mem. 538 F.2d 312 (2d Cir. 1976), cert. denied 425 U.S. 992 (1976). The amounts of interest allocated for the taxable years 1967, 1968, and 1969 were $69,428.49, $68,134.93, and $64,070.31, respectively.

In its amended partnership return for 1975, signed August 13, 1976, after the Supreme Court denied certiorari, CCP claimed a bad debt deduction for the interest allocated for 1967, 1968, and 1969. The taxpayers then filed amended returns for 1975 and refund claims to carryback the net operating loss to the taxable year 1972.

On June 13, 1975, the boards of directors of Stonehedge and Community Technology, Inc. (CTI), and their shareholders,[19] approved the merger of their corporations, together with PRG Enterprises, Inc., another related corporation, which owned all the shares of Village Green of Van Buren, Inc., into CTI. The purpose of this merger was to reduce costs by simplifying their operations. As originally planned, each entity was to serve a particular function, but in practice they began overlapping, complicating both their internal and external dealings.

On or about May 13, 1976, CTI filed a petition in the United States District Court for the Northern District of New York pursuant to Chapter XI of the Bankruptcy Act, coincident with Peter's and Rocco's filing under Chapter XII of the Bankruptcy Act. The primary purpose of filing all three petitions was to renegotiate the secured indebtedness of Peter, Rocco, and CTI.

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[19] In addition to Peter and Rocco, one Alfred Cappuccilli was also a shareholder and director of CTI.

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In its Statement of Affairs filed with the Bankruptcy Court on June 11, 1976, CTI listed total property in the amount of $7,048,737.25, and total debts of $8,970,466.79. These debts, however, included one liability of $1,979,127 which was a mortgage debt against a project which had been conveyed subject to the mortgages, so the value of this property, $2,400,000, was not included as an asset of CTI. Another debt for $1,500,000 included on CTI's debt schedule was secured by certain phases of a project owned by Peter and Rocco, which had a market value in excess of $5,000,000 and was not otherwise encumbered; it, too, was not reflected in CTI's asset schedule.

The secured indebtedness was successfully renegotiated. On or about October 6, 1977, the Bankruptcy Court approved a Plan of Arrangement with the unsecured creditors providing for 100-percent payment of their claims by June 10, 1984. In addition, Peter and Rocco agreed to a subordination of their individual claims against CTI.

In the course of the bankruptcy proceeding, CCP filed a proof of claim in the sum of $325,718.90 for interest allocated by respondent pursuant to section 482 for the period 1967 until March 1972. The Bankruptcy Court disallowed this claim because under New York law, no interest liability by CTI to CCP existed. The United States filed an amicus curiae brief in the Bankruptcy Court opposing CCP's claim on these grounds.

ULTIMATE FINDINGS OF FACT

CCP had a reasonable expectation that, if it had charged interest to Seneca during the taxable years at issue, such interest could have been paid during such years or within a reasonable time thereafter.

CCP had a reasonable expectation that, if it had charged interest to Stonehedge during the taxable years at issue, such

interest could have been paid during such years or within a reasonable time thereafter.

At the time of the sale to Stonehedge, CCP held the Seneca Knolls and Henderson farms properties primarily for sale to its customers in the ordinary course of its trade or business. The sale to Stonehedge took place on December 28, 1962.

OPINION

The parties have presented us with three issues to be resolved. Whether: (1) respondent's allocations of interest to CCP pursuant to section 482[20] for the taxable years 1970, 1971, and 1972 should be upheld;[21] (2) CCP may deduct as a bad debt in either 1972 or 1975 the interest properly allocated to it for the years 1967, 1968, and 1969; and (3) the character of the gain to CCP upon its foeclosure of the mortgages on the Henderson and Seneca Knolls farms.

Petitioners do not dispute the principle that where one member of a group of commonly controlled entities becomes indebted to another but is charged no interest, respondent may

[20] The interest was allocated in respect of the Stonehedge and Seneca mortgages under section 482 rather than section 483 because the sale to Stonehedge occurred prior to July 1, 1963. With respect to the Seneca mortgage, even if it bore interest at six percent (see footnote 10, *supra*) such interest was not paid (nor does the record reveal that CCP reported any such interest on its tax returns for the years at issue) and, in any event, petitioners make no separate argument with respect to respondent's use of a five-percent rate in making his allocation. *Cf. Liberty Loan Corporation v. United States*, 498 F.2d 225, 231-232 (8th Cir. 1974).

[21] Petitioners concede that if interest is properly allocable to CCP under the circumstances herein, the rate utilized by respondent is appropriate. Respondent has allowed Stonehedge and Seneca additional interest deductions for the years in issue in amounts equal to the interest income which he has allocated to CCP under section 482. Section 1.482-1(d)(2), Income Tax Regs.

allocate interest to the creditor under section 482, if interest would have been charged under like circumstances in an arm's-length transaction. *B. Forman Company v. Commissioner*, 453 F.2d 1144 (2d Cir. 1972), affg. in part and revg. in part 54 T.C. 912 (1970). Petitioners acknowledge that no interest was charged during the years in issue, but argue that (a) the corporations and partnership were not commonly controlled, and (b) since interest would not have been accrued under the circumstances by unrelated entities, respondent cannot allocate it under section 482.

We find petitioners' argument that the necessary control (under section 482) did not exist to be frivolous. They contend that when Paduano relinquished his stock interests in 1969, the common control also disappeared. Section 482 and regulations thereunder[22] clearly state that *common control, direct or indirect*, not common ownership, is all that is necessary. *Charles Town, Inc. v. Commissioner*, 372 F.2d 415, 419-420 (4th Cir. 1967), affg. a Memorandum Opinion of this Court. The language is broad and sweeping, and is ample to cover the present case. Cf. *Ach v. Commissioner*, 42 T.C. 114, 125 (1964), affd. 358 F.2d 342 (6th Cir. 1966).

We are to apply a realistic approach to the control question. *B. Forman Company v. Commissioner*, 453 F.2d at 1153.[23] Though there may have been a potential conflict of interest between Paduana and the Cappuccillis, because of the former's continued ownership of a one-third interest in the partnership,

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[22]Section 1.482-1(a)(3).

[23]Since the business entities involved herein are Stonehedge and Seneca, on the one hand, and the CCP partnership on the other, we are not required to decide whether we will accept the full import of the reversal of our holding in *F. Forman Company v. Commissioner*, 453 F.2d 1144 (2d Cir. 1972), affg. in part and revg. in part 54 T.C. 912 (1970).

petitioners have demonstrated no actual conflict.[24] In fact, the only evidence presented indicates that Paduano had retired from active participation in CCP, thereby manifesting common direct control in Peter and Rocco over the entities. Even if the evidence had indicated a continuing active role for Paduano in CCP, we would find the necessary control. In failing to collect interest from Stonehedge and Seneca, CCP was merely continuing its practice established while Paduano was involved in the corporations. We have no evidence that Paduano attempted to change such practice, despite his new status solely as a creditor of the corporations via the partnership, rather than as a shareholder, thereby indicating an acquiescence in the management decisions by Rocco and Peter. Petitioners have failed to convince us that the actual control of the partnership and the corporations was not exercised by the latter two individuals at all times during the taxable years 1970, 1971, and 1972. We, therefore, find the requisite control by the same interests. See also *Grenada Industries, Inc. v. Commissioner*, 17 T.C. 231, 253-254 (1951), affd. 202 F.2d 873 (5th Cir. 1953). In *Dallas Ceramic Co. v. United States*, 598 F.2d 1382 (5th Cir. 1979), *Brittingham v. Commissioner*, 66 T.C. 373, 395-400 (1976), affd. per curiam 598 F.2d 1375 (5th Cir. 1979), and *Cedar Valley Distillery, Inc. v. Commissioner*, 16 T.C. 870 (1951), relied upon by petitioners, the ownership involved was

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[24] Petitioners' argument that "it should be obvious that Paduano was looking forward to having CCP collect its mortgage obligations, including interest, from Stonehedge and Seneca," is ludicrous. CCP had no enforceable right to collect interest from Stonehedge on its mortgage loan under New York law. *New York State Thruway Authority v. Hurd*, 25 NY 2d 150, 158, 303 N.Y.S. 2d 51, 56 (1969). Moreover, he was well aware that CCP had not been collecting interest from either corporation. Paduano's explained absence from the trial means, at most, that his failure to testify will not be held against petitioners (see *Snyder v. Commissioner*, T.C. Memo. 1969-173), not that they may speculate as to what such testimony might have been.

so disparate that the necessary common control under section 482 was found not to exist. These cases are clearly distinguishable.

It is clear that respondent may allocate interest to CCP in respect of its loans to the corporations even if the corporations did not realize income from the loans during the year. *B. Forman Company v. Commissioner, supra; Latham Park Manor, Inc. v. Commissioner,* 69 T.C. 199 (1977). He is to make such allocation —

> in order to prevent "evasion of taxes or clearly to reflect the income." The legislative history of section 482 indicates that it was designed to prevent evasion of taxes by the arbitrary shifting of profits, the making of fictitious sales, and other such methods used to "milk" a taxable entity. The Commissioner has considerable discretion in applying this section and his determinations must be sustained unless he has abused his discretion. We may reverse his determinations only where the taxpayer proves them to be unreasonable, arbitrary, or capricious. * * * *Ach v. Commissioner,* 42 TC at 125-126. [Citations omitted.]

Petitioners argue that the financial status of Stonehedge and Seneca was such that, even if an adequate rate of interest had been charged (as presumably an unrelated third party would have done) such interest would not have been accruable, because there was no reasonable expectation of collection during the taxable years at issue, and that, therefore, respondent was without power to allocate interest income to CCP in respect of those years. Respondent argues that he may apply section 482 to allocate interest income regardless of the debtor's ability to pay (see section 1.482-1(d) (4), Income Tax Regs.) and, in any case, that the financial condition of Stonehedge and Seneca were such that CCP had a reasonable expectation of collecting interest and, therefore, if an adequate interest had been charged, it would have been accruable.

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We deal first with the question as to whether an unrelated taxpayer or CCP (had it charged an adequate rate of interest) would have been required to report for tax purposes interest income during any of the taxable years at issue. Under the accrual method of accounting, income is includable in gross income when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. Section 1.451-1(a), Income Tax Regs. Where, however, income is of doubtful collectibility or it is reasonably certain that it will not be collected within a reasonable time after the taxable year, i.e., in the absence of "reasonable expectancy of its receipt," a taxpayer is justified in not accruing the item. *Corn Exchange Bank v. United States*, 37 F.2d 34 (2d Cir. 1930). The mere financial difficulty of the debtor or postponement of making payment does not constitute the requisite absence of reasonable expectancy of receipt. *Harmont Plaza, Inc. v. Commissioner*, 64 T.C. 632, 650 (1975), affd. by order 549 F.2d 414 (6th Cir. 1977).[25] The determination of whether CCP would have had a "reasonable expectancy" of collecting interest from Seneca and Stonehedge is a question of fact. *Chicago & North Western Railway Co. v. Commissioner*, 29 T.C. 989, 996 (1958). In approaching the question of "reasonable expectancy," we recognize that this involves an exception to the general rule of accruability and that it should be applied narrowly in order that the exception does not swallow up the rule itself. Cf. *Georgia School-Book Depository, Inc. v. Commissioner*, 1 T.C. 463, 469 (1943). Furthermore, we recognize the problem in examining cash flow in the context of leveraged real estate transactions such as Stonehedge engaged in (see *Harmont Plaza, Inc. v. Commissioner*, 64 T.C. at 650), a problem which is accentuated where related corporations and the consequent opportunity for manipulation are involved.

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[25] See also *IDI Management, Inc. v. Commissioner*, T.C. Memo. 1977-369.

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We note initially that, as to Seneca, we have only Peter's self-serving and unsubstantiated testimony that it could not pay interest. Though petitioners filled the record with Stonehedge's tax returns and audited financial statements, the only documentation relating to Seneca was its corporate income tax returns for the fiscal years ending June 30, 1968, and 1969, years not involved herein. These returns show that, although Seneca operated at a loss during those years, it had substantial gross receipts, and there is no evidence that such flow of receipts did not continue during the taxable years 1970, 1971, and 1972 and that interest could not have been paid therefrom.[26] Petitioners have totally failed to carry their burden of proof (*Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure). Accordingly, we uphold respondent's determination that CCP should have accrued interest income due from Seneca during the years in issue. Cf. *Bryan v. Commissioner*, 281 F.2d 238, 243 (4th Cir. 1960), affg. in part and remanding 32 T.C. 104 (1959).

The issue of "reasonable expectancy" as to Stonehedge is not as clear-cut. Throughout the taxable years 1970, 1971, and 1972, Stonehedge's real estate holdings were heavily leveraged. Based upon its tax returns and financial statements during such years, its liabilities far exceeded its assets,[27] it was unprofitable, and it had cash flow problems. But, Stonehedge received substantial amounts of cash during those years which, for aught that appears in the record herein, could have been used to pay interest had it been charged — some $496,000 by way of

[26] See *Merit Tank and Body, Inc. v. Commissioner*, T.C. Memo. 1980-175.

[27] On its balance sheet of December 31, 1970, current assets exceeded current liabilities. The current assets, however, included $250,000 in accounts receivable from related corporations, of which $240,324 was written off as uncollectible in 1971. See footnote 12, *supra*.

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loan from Merchants Bank and $223,756 from the sale of acreage to a third party.

Petitioners' arguments that the proceeds of the Merchants Bank loan could not have been used to pay interest had it been charged are not persuasive. We were not favored with any written evidence as to the terms of the $500,000 loan which would have revealed the restrictions, if any, on the use of funds advanced by the bank thereunder. Nor did the oral testimony of Gschwender (the loan officer of Merchants Bank involved with the loan to Stonehedge) enlighten us on this score. He merely testified that Merchants Bank would have loaned funds for the purpose of paying interest to CCP only on a subordinated basis and did not testify as to the conditions imposed by the bank on the loan actually made. We do not think that the evidence of record as to the collateral and guaranties which Merchants Bank required is sufficient to indicate whether any such restrictions existed, or the nature thereof. Nor were we favored with any evidence as to how the funds received from Merchants Bank were in fact used, although we presume they were used to pay operating expenses which, according to the financial statements, with minor exceptions, did not involve any construction or other direct costs of developing Stonehedge's land. Similarly, no evidence was submitted to show the source of funds with which repayments were made to Merchants Bank.[28] In this connection, we note that in 1971 and 1972 the loan balance was reduced. Thus, we are not satisfied that the funds advanced by Merchants Bank could not have been used to pay interest to CCP during the taxable years at issue.

Our position is reinforced by the fact that during 1970 Stonehedge repaid $120,000 of advances by CCP. Since Stonehedge had only a miniscule amount of income during that year, such

[28]The loans from Merchants Bank aggregated $472,000 at the end of 1971 and $306,000 at the end of 1972.

repayment presumably was made from funds received from Merchants Bank on the theory that such advances were for the purpose of facilitating the development of Stonehedge's properties. The use of such advances to pay interest on CCP's mortgage (had it been charged) could presumably have been supported on the same basis, since the mortgages represented the proceeds of sales of land to Stonehedge for purposes of development.

As far as the $223,756 is concerned, it appears that such payment was necessary to release CCP's mortgage in order that the property in question could be sold. The funds were applied to the discharge of the principal of the mortgage; in fact, there was no reason for it to have been applied otherwise, since at the time of application, *Paduano v. Commissioner*, T.C. Memo. 1975-69, affd. mem. 538 F.2d 312 (2d Cir. 1976), cert. denied 425 U.S. 992 (1976), had not been decided to say nothing of the fact that the deficiency notices which gave rise to the *Paduano* case had not even been issued (they were issued in June 1972). Moreover, under New York law, such application would have been recognized as binding between the parties. Cf. *Foss v. Riordan*, 84 N.Y.S. 2d 224, 233-234 (West. Cty. 1947), affd. 273 App. Div. 982, 79 N.Y.S. 2d 515 (2d Dept. 1948), and cases cited thereat. See *New England Waterworks Co. v. Farmers' L. & T. Co.*, 54 App. Div. 309, 66 N.Y.S. 811, 815 (1st Dept. 1900); *Laney v. Whitaker*, 91 Misc. 2d 949, 398 N.Y.S. 2d 839, 840 (Monroe Cty. 1977), citing *Bank of California v. Webb*, 94 N.Y. 467, 472 (1884). Moreover, respondent's own regulations seem to recognize that payments are applied first to principal (at least in the absence of a contrary application by the parties) in outlining the method by which the time periods for computing allocated interest are determined. See section 1.482-2(a) (3), Income Tax Regs. Under these circumstances, we incline to the view that the $223,756 should not be considered as being available for the payment of the interest allocated in respect of the taxable years at issue.

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However, as we see it, there was still another source of funds which could have been available to pay interest had it been charged. CCP received $404,422 in October 1973 as proceeds from the sale of land. The record does not clearly reveal what land was sold. A part of it ($254,399) apparently was the principal proceeds of the State condemnation award, which for the reasons hereinafter stated (see p. 37, *infra*) we do not believe should be taken into account. The balance of the proceeds ($159,023) apparently came from other land which presumably was available for sale by Stonehedge at an earlier date. Stonehedge's 1973 return shows a cost of the land not involved in the condemnation award as $70,015 which indicates that of the total gain of $204,224 reported — a figure as to which we have been unable to construct a reconciliation on the basis of the record before us — $89,008 ($159,023 less $70,015) was available to pay interest had it been charged.[29]

Based on the foregoing, Stonehedge would appear to have had at least $589,008 available (and possibly more, see footnote 25, *supra*) available cash funds during the taxable years at issue or within a reasonable time thereafter. Granted that it was reasonable to expect that some of these funds were needed for operations (although, as we have pointed out, no hard evidence on this score was forthcoming), there would still seem to have been enough which could have been used to pay interest had it been charged. The amounts of allocated interest to CCP from Stonehedge for the three years at issue herein aggregated only $129,339 (1970 — $61,111; 1971 — $56,564; 1972 — $11,664). If we were to take into account the $196,380 of interest allocated to CCP from Stonehedge for 1967, 1968, and 1969,[30]

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[29]For aught that appears in the record, this land may well have been held free of encumbrances by Stonehedge so that the full $159,663 proceeds from its sale could have been so available.

[30]The remaining $5,254 ($201,634 less $196,380) allocated for these years involved other entities and need not be considered.

we would reach the same conclusion; the aggregate allocated interest for all six years (some $325,719) was still substantially less than the funds which appear to have been available, even after making some allowance for expenditures to cover operating costs.

In sum, petitioners have simply not carried their burden of proof (*Welch v. Helvering, supra;* Rule 142(a), *supra*) that there was not a "reasonable expectancy" that, had such interest been charged Stonehedge by CCP, it could not have been paid.[31]

Petitioners' argument that we should not take allocated interest into account because it was not clear, at least until *Paduano v. Commissioner, supra,* was decided by this Court in 1975, that there was any liability for such interest is beside the point. The test we have applied is, not whether there was a "reasonable expectancy" of collectibility of allocated interest, but whether, if a third party (or CCP) *had in fact charged interest* in the amounts allocated by the respondent, such interest could have been reasonably expected to have been collected. See pp. 27-28, *supra.*

Because we have concluded that respondent's allocation of interest to CCP for the taxable years at issue should be sustained for the reasons stated above, we do not reach respondent's arguments that we should hold that there was a "reasonable expectancy" of collectibility because Stonehedge had available unrealized appreciation in its real estate[32] and

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[31] We reach this conclusion on the basis of a "preponderance of the evidence" standard of proof and, therefore, do not reach the question whether, because section 482 is involved, a higher standard of proof, i.e., that respondent's determination was arbitrary, is required of petitioners on the subsidiary issue of reasonable expectancy.

[32] At trial, because of the manner in which the evidence was developed, the Court stated that, in any event, it was not disposed to deal with this issue.

because of the availability, prior to its assignment to Merchants Bank, of the State condemnation award.[33] Similarly, we do not reach the issue as to whether, even if there was no reasonable expectancy of collectibility, respondent nevertheless had the power to allocate interest by analogy to the "creation of income" cases. See *Latham Park Manor, Inc. v. Commissioner*, 69 T.C. at 214-216, and cases collected thereat; section 1.482-1(d) (4), Income Tax Regs. In this latter connection, we observe that the "creation of income" cases involved the question whether it was material to the existence of respondent's power to allocate income under section 482 that funds represented by non-interest-bearing loans were used to produce income (in which context, the Court of Appeals in *B. Forman Company v. Commissioner, supra*, rejected the standard of correctness "from a pure accounting standpoint" and held that section 482 could be utilized, see 453 F.2d at 1156), whereas, in the instant case, had we found no reasonable expectancy of collectibility, our analysis would have started from the premise that respondent had the power to "create" income under section 482 and would then have proceeded to deal with the question whether the interest income so created should have been included in CCP's income even though an independent third party (or CCP) would not have been required to report such interest had it been charged,[34] a question not faced in the

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[33] We note that this argument has an aura of incongruity, since the amount, if any, which Stonehedge would receive beyond the $13,075 excess over what the State had paid in 1969 was highly speculative; the final award of $245,399 was not made until May 16, 1973, well after the close of the last taxable year involved herein.

[34] See *Pitchford's, Inc. v. Commissioner*, T.C. Memo. 1975-75, where respondent conceded solely for the purposes of that case that section 482 should not be applied under such circumstances — a conclusion which he now characterizes as "inopportune." Section 1.482-1(b)(1), Income Tax Regs., provides:

Footnote continued on next page—

"creation of income" cases.[35]

The next issue to be resolved is whether petitioners are entitled to a bad debt deduction in either 1972 or 1975 for the interest respondent successfully allocated to CCP under section 482 for the years 1967, 1968, and 1969 (see *Paduano v. Commissioner, supra.*)

Petitioners argue that the "debt" became worthless in either 1972 or 1975. Their 1972 claim is based upon *B. Forman Company v. Commissioner, supra,* the first case upholding respondent in his allocation of interest on non-interest-bearing loans under section 482, being decided in that year, including

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—Footnote continued from preceding page

(b) *Scope and purpose.* (1) *The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer,* the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. *The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.* [Emphasis added.]

[35] Respondent's reliance on *Hennessey v. Commissioner,* T.C. Memo. 1977-122, is also misplaced. In that case, we found that Hennessey had a reasonable expectation of collecting interest payments and, therefore, did not have to face this issue. Our passing reference to the fact that the question of reasonable expectation of collectibility is "not entirely distinct from their creation of income argument" is too thin a reed to support respondent's contention.

the denial of a petition for certiorari (407 U.S. 934 (1972)) and a rehearing thereon (409 U.S. 899 (1972)) and their receipt in that year of the deficiency notices for 1967, 1968, and 1969. Their alternative claim for 1975 rests on the fact that in that year, we decided *Paduano v. Commissioner, supra,* upholding respondent's allocation of interest from Stonehedge and Seneca. For the reasons which follow, we hold that if a "debt" was created, it did not come into existence until 1976.

It is well-settled that a debt does not exist for purposes of section 166 where the obligation to repay is subject to a contingency which has not occurred. *Lieberfarb v. Commissioner,* 60 T.C. 350, 354 (1973); *Ewing v. Commissioner,* 20 T.C. 216, 229 (1953). The obligation of the petitioners' in *Paduano v. Commissioner, supra,* to pay the tax on the allocated interest was contingent on both our decision and its affirmance on appeal. *Blake v. Commissioner,* 67 T.C. 7, 18-20 (1976), and cases discussed thereat, affd. as to this issue 615 F.2d 731, 736 (6th Cir. 1980); *North American Coal Corporation v. Commissioner,* 28 B.T.A. 807, 851 (1933). Cf. *United States v. Consolidated Edison Co.,* 366 U.S. 380 (1961); *Lucas v. American Code Co.,* 280 U.S. 445 (1930). See sections 6215 and 7485. See generally, 2 Mertens, Law of Federal Income Taxation (Malone Rev. 1974) sec. 12.66, pp. 267-269. Petitioners argue that the requirements of section 7485 and Rule 192, Tax Court Rules of Practice and Procedure, that the filing of a notice of appeal does not stay assessment or collection of the deficiency determined by this Court unless a bond is filed with this Court, remove the contingency. We disagree. We think it a fair assumption that their appeal of the *Paduano* decision was in good faith and not a dilatory tactic. See section 7482 (c) (4). Thus, we will not now hear petitioners argue that they did not believe their tax liability was in dispute and subject to a real contingency in 1975. Similarly, since the tax liability was contingent until 1976, a debt for it could not

have been in existence in 1972. Petitioners' argument that the debt arose in that year because the deficiency notice was "presumptively correct," is clearly without merit.[36]

Thus far, the discussion has centered on the petitioners' tax liability in *Paduano v. Commissioner, supra,* whereas we are concerned herein with the underlying interest liability. That interest obligation, however, was the alter ego of the tax liability; the allocation of interest was contingent on our tax decision. Had we, or an appellate court, decided in favor of the petitioners in *Paduano,* there would have been no allocation of interest, nor any question as to whether it was a valid and enforceable obligation. Until the decisions were final, therefore, the interest liability (if it ever were to legally arise) was subject to a contingency which had not yet occurred. It is analogous to the situation in which the tax liability is contingent on when the underlying claim is finally resolved. E.g., *Dixie Pine Co. v. Commissioner,* 320 U.S. 516 (1944) (all events have not occurred where liability is contingent and is contested by taxpayer).[37]

We turn now to the final issue, i.e., the character of the gain recognized by CCP pursuant to section 1038 (b) (1), upon the foreclosure of the mortgages on the Seneca Knolls and Hen-

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[36]The effect of the deficiency notice is to place the burden of proof on the issues raised therein on the petitioners. Many petitioners are able to carry this burden, although the petitioners in *Paduano v. Commissioner,* T.C. Memo. 1975-69, affd. mem. 538 F.2d 312 (2d Cir. 1976), cert. denied 425 U.S. 992 (1976), were not. See generally, *Llorente v. Commissioner,* 74 T.C. ____ (May 13, 1980) (Tannenwald, *J.*, concurring).

[37]If a debt was not created, petitioners may be entitled to a loss. See *Tharp v. Commissioner,* T.C. Memo. 1972-10. See also *Corn Exchange Bank v. United States,* 37 F.2d 34, 35 (2d Cir. 1930). Our findings regarding the proper taxable year apply to this issue, as well. Section 1.165-1(d)(1), Income Tax Regs.

derson farms in 1972.[38] The characterization of the gain as ordinary or capital is controlled by the circumstances of the original sale. Section 1.1038-1 (d), Income Tax Regs. Thus, we must decide whether the Seneca Knolls and Henderson farms were capital assets within the meaning of section 1221 in CCP's hands, when originally sold to Stonehedge.

Section 1221 (1) denies capital gain treatment to gains arising from the sale of "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The purpose of this provision "is to differentiate between 'the profits and losses arising from the everyday operation of a business' on the one hand * * * and 'the realization of appreciation in value accrued over a substantial period of time' on the other, * * *." *Malat v. Riddell,* 383 U.S. 569, 572 (1966).

The ultimate determination is a factual one, to be based on all the surrounding circumstances. *Adam v. Commissioner,* 60 T.C. 996, 999 (1973). Rather than list the factors deemed relevant by the courts (see e.g., *Gault v. Commissioner,* 332 F.2d 94, 96 (2d Cir. 1964), affg. a Memorandum Opinion of this Court; *Adam v. Commissioner, supra*), we shall only discuss those relevant to our decision herein. The relationship among the factors and their mutual interaction changes in each case depending on the facts. *Biedenharn Realty Co. v. United States,* 526 F.2d 409, 415 (5th Cir. 1976). The focus of the factual inquiry is the statutory tests, i.e., (1) what was CCP's trade or business? (2) was CCP holding the property primarily for sale in the ordinary course of its trade or business and (3) was Stonehedge a customer of CCP in that trade or business? Cf. *Suburban Realty Co. v. United States,* 615 F.2d 171, 178 (5th Cir. 1980).

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[38] Petitioners concede that the amount of said gain is $482,577.

APPENDIX D
Opinion of United States Tax Court

Petitioners argue that CCP and Stonehedge were separate taxable entities, as were the partner/shareholders, so that the activities of each should not be attributed to the others. See *Gordy v. Commissioner*, 36 T.C. 855 (1961). They then argue that CCP merely acquired the individual farms as a speculative investment, assembling enough contiguous parcels to make it worthwhile for a purchaser to seek a zoning change. They claim that CCP undertook no other activity to rezone, subdivide, or otherwise improve the land, nor any sales activities. In addition, they deny that CCP was in the trade or business of selling land, claiming that its real estate transactions were few and isolated.[39]

The developers were careful, on paper, to separate their activities and those of Stonehedge from the partnership's, but that is where the separation ended. CCP cannot be permitted to insulate itself from the acts of an entity (Stonehedge) whose efforts are so closely related to its own;[40] the supplier of developable land may be regarded as a joint participant with the builder in an integrated real estate development business. *Bauschard v. Commissioner*, 31 T.C. 910, 916-917 (1959), affd. 279 F.2d 115, 118 (6th Cir. 1960). Cf. *Pointer v. Commissioner*, 48 T.C. 906, 917 (1967), affd. 419 F.2d 213, 216 (9th Cir. 1969). Peter explained the role each entity played in their development plan. The jointness of the venture may be seen from how the land sales were structured — no interest was actually charged on either the Henderson or Seneca Knolls mortgages, repayment was scheduled over several years as the land was expected to be developed and resold, delivery of the deed was held up until the principals believed (incorrectly) that

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[39]Petitioners do not question that Stonehedge was holding property for sale to customers in the ordinary course of its trade or business.

[40]See and compare *Bush v. Commissioner*, T.C. Memo. 1977-75, affd. 610 F.2d 426 (6th Cir. 1979).

the zoning would be approved, and essentially all of the risk of non-development fell on CCP, which apparently expected no payment until the buildout had proceeded and did not foreclose until it had abandoned its development plan, at least with respect to the use of Stonehedge.[41] In this context, we hold that CCP was in the trade or business of land development and sales at the time the Seneca Knolls properties were sold.

From the record, it is clear that CCP acquired and held the farms intending to resell them to Stonehedge.[42] These contiguous parcels lay between the already completed sections of Seneca Knolls and were included in Stonehedge's master plan of development which had been previously filed with the Town of Van Buren. Furthermore, we have found that the developers' method of operation was to have CCP acquire the land and Stonehedge develop it. The fact that the sale here was to one customer does not prevent characterization of the gain as ordinary income. *Pointer v. Commissioner,* 48 T.C. at 917.[43] Thus, the sale was of land primarily held for sale to a customer in the ordinary course of CCP's trade or business. The gain

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[41] While Merchants Bank anticipated repayment from the "buildout," it also required a minimum payment schedule and did not offer this entire package of benefits.

[42] Even with our finding that certain of the properties were not sold to Stonehedge until December 28, 1962 (see footnote 43, *infra*), the sales of the parcels involved herein to Stonehedge by CCP took place within a short period of time after their acquisition by the latter — the longest period CCP held any such parcel was from February 2, 1961 to December 28, 1962, less than two years.

[43] Our ultimate finding of fact as to the date of the sale by CCP to Stonehedge (see p.21, *supra*) has been included solely in the interests of completeness. In light of our conclusion, the holding period of CCP has no effect on the character of the gain therefrom. Moreover, also in the interest of completeness, we note that we have taken into account, in making our finding of fact, certain admissions against interest revealed in the record.

reported by CCP on the foreclosure of the mortgages is, therefore, taxable to CCP and through it to petitioners as ordinary income.[44]

Decisions will be entered for the respondent.

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[44]See also *Bush v. Commissioner, supra*, footnote 40.

APPENDIX E
DECISION AND ORDER OF U.S. DISTRICT COURT OF NEW YORK

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF NEW YORK

IN THE MATTER
OF

COMMUNITY TECHNOLOGY, INC.

Debtor

NO. 76-BK-1130

Decision and Order

HON. BERYL E. McGUIRE
Bankruptcy Judge

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF NEW YORK

IN THE MATTER
OF

COMMUNITY TECHNOLOGY, INC.

Debtor

76-BK-1130

Menter, Rudin and Trivelpiece, P. C. (A. Solomon Menter, Esq., of counsel), Syracuse, New York, Attorneys for Community Technology, Inc.

APPENDIX E

Decision and Order of U.S. District Court Of New York

Bond, Schoeneck & King (James E. Walsh, Esq., of counsel), Syracuse, New York, Attorneys for Official Creditors' Committee

Victor Chini, Esq., Syracuse, New York, Attorney for Cappuccilli, Cappuccilli & Paduano

McGuire, BJ*

On May 6, 1976, Community Technology, Inc. (hereinafter referred to as CTI) filed a petition under the provisions of Chapter XI of the Bankruptcy Act. A plan of arrangement has been submitted to and accepted by creditors. The plan was confirmed on October 6, 1977.

In the course of this proceeding, Cappuccilli, Cappuccilli and Paduano, a partnership (hereinafter referred to as CCP), filed a proof of claim in the sum of $325,718.90. The proof of claim describes the indebtedness due the partnership as follows:

> "Interest on a note and purchase money mortgage and on cash advances for the years 1967 — March 1972 due and owing from Stonehedge Development Corporation which was merged into Debtor on July 1, 1975",

and further as "being deficiency assessments for interest income by the Internal Revenue Service."

The debtor, CTI, joined by the official creditors' committee. has objected to the allowance of the claim on the ground that the note secured by a mortgage between Stonehedge Development Corporation (since merged into CTI) and CCP expressly and, under New York Law, legally provided for no interest. CCP has appeared in opposition to the debtor's motion.

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*Sitting by designation pursuant to § 43(c) of the Bankruptcy Act [11 U.S.C. § 71(c)].

APPENDIX E

Decision and Order of U.S. District Court Of New York

The matter has been submitted upon a stipulated set of facts; the contents of which are hereby incorporated by reference.

I

During the years in question, Gerald Paduano, Rocco Cappuccilli and Peter Cappuccilli were equal partners in CCP. They also were equal shareholders in Stonehedge Development Corporation. Relative to the non interest bearing real estate and mortgage transaction hereinbefore referred to, the Commissioner of Internal Revenue, pursuant to § 482 of the Internal Revenue Code, imputed interest income of $196,330.19 to the partnership for the years 1967, 1968 and 1969.

Disputing that ruling, the three partners and their wives petitioned the Tax Court. That Court upheld the Commissioner as did the 2nd Circuit Court of Appeals, and certiorari to the United States Supreme Court was denied.[1]

II

Because CCP's argument in opposition to CTI's and the creditors' committee's objection suggested that disallowance of its claim at least in part would create a conflict in decision as between this Court and the Tax Court and the Second Circuit Court of Appeals, this Court called for the briefs to those Courts and, in addition, invited the Government to file an Amicus brief on the point. The Government, with little dispatch, filed its brief at Utica on February 16, 1978.

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[1]See Paduano v. C.I.R. TCM 1975-69 (TC 1975), aff'd. w/o opinion, 538 F2d 312 (2nd Cir. 1976), cert. den., 96 S. Ct. 2204 (1976).

APPENDIX E

Decision and Order of U.S. District Court Of New York

In substance, the Government agrees with CTI and its creditors' committee that New York Law controls and that under New York Law and the facts of this case no interest liability by CTI to CCP would exist.[2] It points out that, under § 482, the respective rights and liabilities of parties for tax purposes only may be viewed quite differently from those under state law.

Extended discussion of the Government's views on the subject is not necessary. From its review, the Court now is satisfied that New York Law controls, that under New York Law CCP has no valid claim against the debtor for interest, and that neither the decision of the Tax Court nor Second Circuit Court of Appeals suggests a contrary view.

Accordingly, the objections of CTI and its creditors' committee are sustained, and claim number 135 is disallowed.

So Ordered.
Dated: February 22, 1978

/s/ BERYL E. McGUIRE
Bankruptcy Judge

RECEIVED
AND
FILED
FEB 23 1978
OFFICE OF BANKRUPTCY JUDGE
UTICA, N.Y.

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[2]See Woerz v. Schumacher, 161 NY 530 (1900); New York State Thruway Authority v. Hurd, 25 NY2nd 150 (1969).

UNITED STATES CONSTITUTION — FIFTH AMENDMENT

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a grand jury, except in cases arising in the land or naval forces, or in the militia, when in actual service in time of war or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case, to be a witness against himself; nor be deprived of life, liberty, or property, without, due process of law; nor shall private property be taken for public use, without just compensation.

APPENDIX F
STATUTES AND REGULATIONS

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 165. LOSSES.

(a) *General Rule.* — There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.* — For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

* * *

SEC. 166. BAD DEBTS

(a) *General Rule.* —

(1) *Wholly worthless debts* — There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.* — When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) *Amount of deduction.* — for purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

* * *

APPENDIX F
Statutes and Regulations

SEC. 482 *ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.*

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Sec. 1221 [1954 Code]. For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

* * *

Sec. 6601 [1954 Code]. (a) General Rule. — If any amount of tax imposed by this title (whether required to be shown on a return, or to be paid by stamp or by some other method) is not paid on or before the last date prescribed for payment, interest on such amount at an annual rate established under section 6621 shall be paid for the period from such last date to the date paid.

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§1.166-1. *Bad debts.*

(a) *Allowance of deduction.* Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

APPENDIX F
Statutes and Regulations

(2) A deduction for a reasonable addition to a reserve for bad debts.

* * *

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt is not due at the time of deduction shall not of itself prevent its allowance under section 166. For the disallowance of deductions for bad debts owed by a political party, see § 1.271.1.

* * *

§ 1.482-1 *Allocation of income and deductions among taxpayers.*

(a) *Definitions.* When used in this section and in § 1.482-2—

* * *

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

* * *

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the

conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

* * *

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * *

APPENDIX F
Statutes and Regulations

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(d) *Method of allocation.* (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. See § 1.482-2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U. S. income tax

liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member is such adjustment would have an effect on the U. S. income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a "pending taxable year" is any taxable year with respect to which the U. S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no effect on the U. S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U. S. income tax liability of such member for a later taxable year, or for the purposes of determining the U. S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

* * *

§ 1.482-2. *Determination of taxable income in specific situations.*

(a) *Loans or advances* — (1) *In general.*

Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

* * *

APPENDIX F
REVENUE PROCEDURE 65-17, 1965-1CB 833

Technical position and procedure governing the adjustment of accounts and the transfer of amounts as the result of allocations of income or deductions made pursuant to section 482 of the Internal Revenue Code of 1954 (section 45 of the Internal Revenue Code of 1939).

SECTION 1. SCOPE.

This Revenue Procedure prescribes the position of the Internal Revenue Service and the procedures to be followed in cases in which a United States taxpayer, whose taxable income has been increased for a taxable year by reason of an allocation under section 482 of the Internal Revenue Code of 1954 (section 45 of the Internal Revenue Code of 1939), requests permission to receive payment from the entity from, or to, which the allocation of income, or deductions, was made of an amount equal to a part or all of the amount allocated, without further Federal income tax consequences.

SECTION 2. BACKGROUND AND PURPOSES.

Section 482 of the Code gives the Internal Revenue Service authority to "distribute, apportion or allocate gross income, deductions, credits, or allowances" among certain related organizations, trades or businesses if it "determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income" of any such entity. In applying section 482, the Service will, in appropriate cases and pursuant to a closing agreement, permit taxpayers whose income has been increased by the Service under section 482 of the Code to make certain adjustments to conform their accounts to reflect the section 482 allocations. The cases in which such adjustments will be permitted are outlined in section 3, below. The types of adjustment permitted are described in section 4 and the prescribed procedures are set forth in section 5. Any reference in this Revenue Procedure to

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Revenue Procedure 65-17, 1965-1CB 833

an increase in taxable income shall also be deemed a reference, in an appropriate case, to a reduction in a taxpayer's loss.

SECTION 3. CASES IN WHICH ADJUSTMENT OF ACCOUNTS WILL BE PERMITTED.

A United States taxpayer shall qualify for the treatment provided in this Revenue Procedure:

.01 If for a taxable year beginning prior to January 1, 1963, the taxable income of such taxpayer is increased by the Internal Revenue Service under section 482 of the Code, or

.02 If for a taxable year beginning after December 31, 1962, the taxable income of such taxpayer is increased by the Internal Revenue Service under section 482 of the Code and it is determined by the Service that the arrangements or transactions, or the terms thereof, giving rise to the section 482 allocation did not have as one of their principal purposes the avoidance of Federal income tax. The determination as to whether one of the principal purposes was avoidance of Federal income tax will be based upon all the facts and circumstances of the case. Among the factors which will be considered are the dividends received from the corporation with which the transaction or arrangement giving rise to the section 482 allocation was consummated, whether the taxpayer attempted in good faith to comply with the regulations theretofore promulgated under section 482 of the Code, the extent to which the arrangement contravened such regulations, and the amount of income tax, including any income tax levied by a foreign country, which resulted from the transaction. The relative weight to be given any one factor will depend on the facts of each case. The fact that the other party to the transaction or arrangement giving rise to the section 482 allocation is a foreign corporation or a Western Hemisphere trade corporation shall not in and of itself be a basis for a finding that one of the

APPENDIX F
Revenue Procedure 65-17, 1965-1CB 833

principal purposes of the transaction or arrangement was avoidance of Federal income tax.

.03 A taxpayer shall not qualify under section 3.01 or 3.02, above, for the treatment provided in this Revenue Procedure if any part of any underpayment of tax by such taxpayer for the taxable year involved in the allocation is due to fraud.

SECTION 4. ADJUSTMENTS TO BE MADE OR ALLOWED.

.01 If a taxpayer qualifying under section 3 above complies with the requirements of section 5 below, such taxpayer shall be permitted to exclude from his gross income all or part of any dividend which

(1) was received from the corporation (as defined in section 7701(a) (3) of the Code) with which it engaged in the transaction or arrangement giving rise to the section 482 allocation (the "other corporation") and

(2) was included in the gross income of the taxpayer as a dividend (within the meaning of section 316 of the Code) for the year for which the allocation is made,

provided that the amount so excluded shall not exceed the amount of the increase in the taxable income of such taxpayer resulting from the section 482 allocation from the other corporation less the amount of any offset which is allowed to the taxpayer under section 3 of the Revenue Procedure 64-54, 1964-2 CB 1008, with respect to such section 482 allocation. To the extent that a dividend is excluded from income pursuant to this paragraph, it shall cease to qualify as a dividend under section 316 of the Code or a distribution under section 963 of the Code or as a dividend for any Federal income tax purpose; for instance, no foreign tax shall be deemed to have been paid with respect thereto under section 902 of the Code for the purpose of

APPENDIX F
Revenue Procedure 65-17, 1965-1CB 833

the credit allowed under section 901 of the Code and no dividend received deduction shall be allowed with respect thereto under sections 241 through 247 of the Code. An amount includable in income under sections 551 or 951 of the Code shall not be considered a dividend for purposes of this paragraph.

.02 If a taxpayer qualifying under section 3, above, complies with the requirement of section 5, below, such taxpayer shall be entitled to establish an account receivable from the entity with which it engaged in the transaction or arrangement giving rise to the section 482 allocation (the "other entity"). Such account receivable shall not exceed

(1) The amount of the increase in the taxable income of such taxpayer resulting from the section 482 allocation from the other entity, less

(2) The amount of any offset which is allowed to the taxpayer under section 3 of Revenue Procedure 64-54 with respect to such section 482 allocation, and less

(3) Any amount excluded by the taxpayer pursuant to section 4.01, above, and plus

(4) The interest accrued on such account receivable and included in taxable income pursuant to section 4.03, below.

Except as provided in section 4.03, below, the account receivable may be established and paid without tax consequences, provided that such account receivable is paid within 90 days after the date of the closing agreement required by section 5.013, below. Payment must be in the form of money, a written debt obligation payable at a fixed date and bearing interest at an arm's length rate determined in the manner provided in section 1.482-2(a)(2) of the Income Tax Regulations (or the proposed regulations if such regulations are not yet in force), or an accounting entry offsetting such account

APPENDIX F
Revenue Procedure 65-17, 1965-1CB 833

receivable against an existing debt owed by the taxpayer to the other entity.

.03 The account receivable established in accordance with section 4.02, above, (except for the accrued interest) shall be deemed to have been created as of the last day of the taxpayer's taxable year for which the allocation under section 482 of the Code is made. Such account receivable shall bear interest at an arm's length rate, computed in the manner provided in section 1.482-2(a)(2) of the Income Tax Regulations (or the proposed regulations if such regulations are not yet in force), from the day after the date the account is deemed to have been created or from the first day of the taxpayer's first taxable year beginning after December 31, 1962, whichever is later, to the date of payment. The interest so computed shall be accrued and included in the taxpayer's taxable income for each taxable year during which the account receivable is deemed outstanding.

.04 A taxpayer's election to avail itself of the provisions of this Revenue Procedure shall in no way affect the allocation made by the Service under section 482 of the Code. Such election shall, however, affect the taxpayer's taxable income and credits to the extent indicated by sections 4.02 and 4.03, above.

* * *

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PURCHASES BY PARTNERSHIP					SALES TO STONEHEDGE	
(1) Farm	(2) Owner	(3) Option	(4) Total Price	(5) Date of Purchase		(7) Selling Price
Henderson	Easter	12/07/59	$125,460	3/08/60	"Henderson Farm"	$ 216,500
Patterson	Patterson	9/01/60	22,400	11/24/61))		
Commane	Commane	11/19/58	71,830	10/20/61))		
Walter	Walter	2/07/58	64,065	2/22/61))	"Seneca Knolls Property"	1,353,600
Green	Green	3/15/60	34,788	10/26/61))		
Higgins	Hunt	10/13/58	127,000	1/03/62)		

Office - Supreme Court, U.S.
FILED
JUN 14
ALEXANDER L. STEVAS,

No. 81-1894

In the Supreme Court of the United States

OCTOBER TERM, 1981

GRACE CAPPUCCILLI, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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GRACE CAPPUCCILLI, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In this federal income tax case, petitioners seek review of the decision below upholding the Commissioner's allocation under Section 482 of the Internal Revenue Code of interest income from Stonehedge Development Corporation to a related partnership, which resulted in an increase in each partner's distributive share of partnership income.

The relevant facts may be summarized as follows: In 1953, Peter and Rocco Cappuccilli and Gerald Paduano organized the Stonehedge Development Corporation (Stonehedge), which they owned in equal shares.[1] The three were

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[1]In 1977, Peter and Rocco Cappuccilli filed bankruptcy petitions. They are not parties to this action. The tax liabilities in dispute are those of their wives, Grace and Dorothy Cappuccilli, who filed joint income tax returns with their husbands for the years in question. The tax liabilities are based upon the business ventures of Peter and Rocco.

also equal partners in a firm called Cappuccilli, Cappuccilli and Paduano (CCP). The Cappuccillis and Paduano held their interests in the two entities until 1969 when Paduano retired from active participation in the operation of the businesses and sold all of his stock in Stonehedge to the Cappuccillis. Paduano thereafter remained a one-third partner in CCP (Pet. App. 16a-18a).

During 1961-1962, CCP acquired several contiguous parcels of undeveloped real estate, for a total consideration of $445,723. It then resold those parcels to Stonehedge in two separate sales on February 20, 1961, and December 28, 1962, for a total consideration of $1,570,327.39—including two promissory notes from Stonehedge to CCP. One note, in the principal amount of $81,000, bore interest at an annual rate of 6%. The other note, in the principal amount of $1,075,000, bore no interest. Stonehedge held the bulk of that land until 1972, but was unable to develop it as planned, due to zoning problems that could not be resolved.[2] In 1972, Stonehedge reconveyed the property to CCP in full satisfaction of the balance of the two promissory notes. During the time that Stonehedge held the land, it made some payments on the principal balance of the two notes but did not pay CCP any interest (Pet. App. 2a-5a).

On audit, the Commissioner invoked his authority under Section 482 of the Code and increased CCP's taxable income for 1967, 1968 and 1969 by a total of $325,718.90—representing applicable market rate interest on the unpaid balance of the notes. That allocation was sustained in

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[2]The Tax Court found that the original plan of the Cappuccillis and Paduano was to have CCP assemble a parcel of land suitable for development and then sell it, at a substantial profit, to Stonehedge, which would construct houses or other buildings and sell to the ultimate purchasers (Pet. App. 17a).

Paduano v. *Commissioner*, T.C. Mem. Dec. (P-H) para. 75,069 (1975), aff'd, 538 F. 2d 312 (2d Cir.), cert. denied, 425 U.S. 992 (1976). This case involves similar allocations for 1970, 1971 and 1972.[3] In addition, the Commissioner determined that the 1972 gain of $482,577 realized by CCP under Section 1038 of the Code on the reacquisition of the land from Stonehedge was taxable to the partnership as ordinary income rather than as long-term capital gain. The Tax Court upheld the Commissioner's determinations (Pet. App. 14a-45a) and the court of appeals affirmed (Pet. App. 1a-9a).

1. The decision correctly upheld the Commissioner's allocation of interest income under Section 482. Here, the device of interest free loans among related entities was used to reduce Stonehedge's losses (by the amount of interest it did not pay) and to reduce CCP's income (by the amount of interest it did not receive). This is precisely the type of manipulation of commonly controlled entities against which Section 482 is directed. See *B. Forman Co.* v. *Commissioner*, 453 F. 2d 1144, 1150-1152 (2d Cir.), cert. denied, 407 U.S. 934 (1972). See also *Kahler Corp.* v. *Commissioner*, 486 F. 2d 1 (8th Cir. 1973); *Kerry Investment Co.* v. *Commissioner*, 500 F. 2d 108 (9th Cir. 1974); *Fitzgerald Motor Co.* v. *Commissioner*, 508 F. 2d 1096 (5th Cir. 1975).

Contrary to petitioners' argument (Pet. 5-9), the decision below does not confilct with *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1973). There, the Court held that income could not be allocated under Section 482 to a company which was legally prohibited from receiving the

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[3]The Commissioner allowed Stonehedge corresponding income tax deductions for the interest income imputed to CCP.

income.[4] No such prohibition, however, is involved in this case. Had the transaction here been at arm's-length, CCP could legally have charged and Stonehedge could legally have paid interest on the loans. CCP, however, did not charge any interest to Stonehedge. *First Security Bank* is therefore distinguishable.

2. Nor does the increase in the Paduanos' taxable income violate their constitutional rights even though they were not shareholders of Stonehedge, as petitioners now contend (Pet. 11-12).[5] Gerald Paduano was a one-third partner in CCP during the years at issue. As such, he was taxable on his distributive share of the partnership's correct taxable income whether or not he received it. See *United States* v. *Basye*, 410 U.S. 441, 446-448 (1973). The allocation of interest income to CCP and then, pursuant to the rules of partnership taxation, to the individual partners, was not based on some supposed benefit the partners received as shareholders of Stonehedge. Rather, the allocation was made in order to correct distortions in income caused by non arm's-length dealings between the two commonly controlled entities, CCP and Stonehedge. Those distortions

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[4]The other cases cited by petitioners (Pet. 7), *viz.*, *Delta Life Insurance Co.* v. *United States*, 363 F. Supp. 410 (E.D. La. 1973); *Bunker* v. *Commissioner*, T.C. Mem. Dec. (P-H) para. 79,174 (1979); and *Bank of Coushatta* v. *United States*, 650 F. 2d 75 (5th Cir. 1981), do not conflict with the decision below. In *Bank of Coushatta*, the court held that insurance commissions would not be taxed to a bank which transferred its insurance sales business under a good faith belief that receipt of insurance sales commissions by the bank would be illegal. In *Delta Life Insurance Co.*, *supra*, the court simply held that the Commissioner could not, under Section 801 of the Code, require the taxpayer to carry for tax purposes a reserve smaller than that actually required by state law. These cases turn on legal constraints not present in this case. *Bunker* v. *Commissioner*, *supra*, involved an installment sale question unrelated to this case and is entirely inapposite.

[5]This issue was never raised by petitioners below (Pet. App. 9a).

exist, and the Commissioner properly invoked Section 482 to correct them, whether or not the Paduanos benefited from the distortions in income in their capacity as shareholders of Stonehedge.

3. The decision below also correctly rejected petitioners' claim that the partnership was entitled, in 1975, the year prior to Stonehedge's bankruptcy, either to a bad debt deduction or to a business loss deduction with respect to the allocated interest. Stonehedge never paid the interest. The crux of this matter is that Stonehedge never had any obligation to pay the interest. There was no debt and no loss. By failing to charge an arm's-length interest rate on loans from CCP to Stonehedge, the partners in CCP perhaps used the assets of CCP to make a contribution to Stonehedge in the amount of the interest not charged, and may be entitled to increase their bases in the Stonehedge stock to reflect this contribution. However, the transaction also reduced the income of CCP and increased the income (or reduced the losses) of Stonehedge. As the court of appeals correctly recognized, it was precisely such a shifting of income between related entities that Section 482 was intended to rectify (Pet. App. 51). Allowing petitioners an income tax deduction merely because Stonehedge did not actually pay the imputed interest to CCP[6] would serve to nullify the Commissioner's allocation (Pet. App. 61).[7]

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[6]The Tax Court found that, contrary to petitioners' claim, Stonehedge probably would have been able to pay CCP a fair rate of interest on the notes in question had it been required to do so (Pet. App. 27a-28a). The court of appeals determined that this finding was not clearly erroneous (Pet. App. 7a).

[7]Petitioners claim (Pet. 9-10) that this case involves an unconstitutional retroactive application of the Treasury Regulations under Section 482. But whether or not the Treasury Regulation under which the Commissioner made his allocation in this case is broader than the general understanding of Section 482 at the time the loans in issue were

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

JUNE 1982

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made, it is clear that Treasury Regulations may be applied retroactively. See Section 7805(b) of the Internal Revenue Code of 1954 (26 U.S.C.); *Dixon* v. *United States*, 381 U.S. 68, 71, 74-75 (1965); *Automobile Club* v. *Commissioner*, 353 U.S. 180, 184-186 (1957).

Finally, petitioners claim (Pet. 20-22) that the gain realized by CCP on the reacquisition of the land from Stonehedge should be taxed as long-term capital gain rather than ordinary income. The character of the gain taxable under Section 1038 of the Code on repossession of real property by the vendor is the same as the character of the gain realized on the original sale. Treasury Regulations on Income Tax (1954 Code), 26 C.F.R. 1.1038-1(d). The court of appeals correctly noted (Pet. App. at 7a-8a) that the gain on the original sale was taxed to CCP as ordinary income, and that the record demonstrates that the gain was in fact the "profits and losses arising from the everyday operation of a business" rather than from investments in capital assets. See *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52 (1955).

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In The

Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-1894

GRACE CAPPUCCILLI, ET AL.,

Petitioners,

— v. —

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONERS' REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

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1. Respondent argues that *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, is distinguishable because during the years 1970, 1971 and 1972 there was no legal prohibition by Stonehedge to pay the (imputed) interest to CCP. Respondent's reasoning is that had CCP (in 1962-the time of the installment sale) charged interest, then Stonehedge could have legally paid it during the years in issue. (R. 3,4)

First, there was no requirement under the federal income tax laws to charge interest (on related party transactions) prior to 1968. (Pet. 9) Secondly, the question involved is *whether during the years 1970, 1971 and 1972, Stonehedge was legally prohibited from paying interest to CCP*; and the answer is yes, according to the Bankruptcy Court's decision. (Pet. 6) Accordingly, the holding of *First Security Bank* should apply.

2. As to the violation of Paduano's constitutional rights, Petitioners in their brief to the Second Circuit argued that Mr. Paduano derived no economic benefit during 1970, 1971 and 1972 on interest free loans from CCP to Stonehedge, because Mr. Paduano had relinquished his interest in Stonehedge during 1969. Petitioners stated that on the contrary, as a creditor, Mr. Paduano suffered financial loss due to the failure by Stonehedge to pay principal payments timely and by the failure to pay interest. (Appellants' Brief to Second Circuit pp. 22-24)

In any event, this Court has held that in the interest of Justice a new issue may be considered on appeal. *Hormel* v. *Helvering*, 312 U.S. 552.

3. *The Commissioner apparently rejects the Second Circuit's "double deduction" theory because he argues that:*

> "The partners in CCP perhaps used the assets of CCP to make a contribution to Stonehedge in the amount of interest not charged; and may be entitled to increase their basis in the Stonehedge stock to reflect this contribution".

If the Commissioner supported the "double deduction" theory why would it be necessary to give "additional" tax relief to Petitioners in the form of an increase in stock basis.

Further, if Respondent is permitted to assert the capital contribution theory then Petitioners could also argue that the entire loans (and installment note) were not in fact loans but capital contributions in which case no interest allocation would apply. This was one of the theories advanced by the taxpayers in the *Forman* case and the Second Circuit Court rejected it totally, stating: "there is no evidence in the record that the

taxpayers received additional stock in Midtown for these alleged capital contributions", *B. Forman Co.* v. *Commissioner*, 453 F2d, 1144, 1156 cert. denied, 407 U.S. 934; nor is there evidence in the instant case that Petitioners received additional stock in consideration for the imputed interest which they did not receive.

Finally, the government's "capital contribution"(1) theory fails to explain how a former shareholder like Paduano could receive an increase in his stock basis some ten or more years (1969) after divesting himself of his interest in the corporation. It is clear that Paduano's ability to recognize an increase in his stock basis would have been foreclosed three years after filing his 1969 tax return (the statute of limitations for filing amended returns). Also, the government's theory would unfairly discriminate against shareholders who have sold their stock and against donees who have received such stock from donors with an obviously reduced basis. Section 1015 IRC.

Respondent argues that Petitioners are not entitled to a bad debt loss or business loss deduction on the theory that Stonehedge had no obligation to pay the interest - "there was no debt and no loss". (R. 5) The fact that Petitioners paid federal income taxes on $325,718.00 of fictional income plus interest on said taxes from 1967 cannot be denied (New York State income taxes would also have to be paid, since New York applies federal adjustments to its taxes). The *total loss to Petitioners* of federal and state income taxes plus accrued interest from 1967 would approximate $243,000.00.(2) Since this loss resulted from a tax asserted by the Commissioner on phantom income, Petitioners' relief would be in the form of a loss deduction (phantom or otherwise) to recover all or part of said tax payments.

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(1) The capital contribution theory was argued by the Commissioner in both the United States Tax Court and the Second Circuit Court; neither Court adopted this theory.

(2) See affidavit of Paul Kinlry, CPA; Appendix.

The Commissioner also argues that the granting of a deduction would "serve to nullify the Commissioner's allocation". (R. 5) But the tax law allows deductions for bad debts and business losses, and Petitioners are asking for no more than that which is allowed to non-related parties in similar circumstances. (Pet. 17)

To sum up, it should be noted that the Second Circuit Court relied upon a "double deduction" theory; a theory which was not argued by the Commissioner either in the Tax Court or the Second Circuit Court, and which was not even mentioned by the Commissioner in his Memorandum in Opposition. *Therefore, it appears that the Commissioner agrees with the Petitioners that the "double deduction" theory of the Second Circuit is incorrect as a matter of law.*

4. As to the retroactive application issue (R. 5, footnote 7) the cases cited by the Commissioner preceded *U.S. v. Darusmont*, 449 U.S. 292 which apparently is the latest authority on that question. That Court stated:

> Usually the "retroactive" feature has application only to that portion of the current calendar year preceding the date of enactment, but each of the Revenue Acts of 1918 and 1926 was applicable to an entire calendar year that had expired preceding enactment. This "retroactive" application apparently has been confined to short and limited periods required by the practicalities of producing national legislation. We may safely say that it is a customary congressional practice.
>
> [No per se violation]
>
> The Court consistently has held that the application of an income tax statute to the entire calendar year in which enactment took place does not per se violate the Due Process Clause of the Fifth Amendment. (Citations omitted)

5. Concerning the capital gain argument (R. 6, unnumbered footnote), the Commissioner argues that "the record demonstrates that the gain was in fact the profits and losses arising from the everyday operation of a business". However, the record apparently was not that clear to the Tax Court

Judge, the trier of facts, because he had to rely on a joint venture theory (a theory not adopted by the Second Circuit) in order to find that Petitioners were developers.

It is therefore submitted that the petition for a writ of certiorari should be granted.

VICTOR CHINI, ESQ.
Attorney for Petitioners

Stanley Germain, Jr., Esq.,
Of Counsel.

STATE OF NEW YORK)
COUNTY OF ONONDAGA) SS:

PAUL KINIRY, being duly sworn deposes and states:

1. That he is a certified public accountant and associated with Kiniry & Misner, P. C., Certified Public Accountants, with offices at 815 State Tower Building, Syracuse, New York.

2. That he made a computation for the partners of CCP of the federal income taxes and interest from 1967 paid to the Internal Revenue Service on the imputed interest income issue for the years 1967 through 1972 which totalled $218,000.00 and which amount was paid before June 1982.

3. That he made a computation for the partners of CCP of the estimated taxes and interest from 1967 due to New York State for the years 1967 through 1972 which totalled approximately $25,000.00.

4. That as of this date the amounts due New York State have not been paid.

5. That the total amount of all federal and New York State taxes and accrued interest from 1967 on the imputed interest income allocated under Section 482 for the years 1967 through 1972 is approximately $243,000.00.

Paul Kiniry
Paul Kiniry

Sworn to before me this
28th day of June, 1982.

Jeannine Tartaro
Notary Public

JEANNINE TARTARO
Notary Public in the State of New York
Qualified in Onondaga Co. No. 4641236
My Commission Expires March 30, 19 84